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Supreme Court of the United States

October Term, 1963

No. 63

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN.

Brief Amicus Curiae in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

Supreme Court of the United States

October Term, 1963
No. 1041

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN.

Brief Amicus Curiae in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The undersigned is attorney for West Los Angeles Institute for Cancer Research (herein called the "Institute") and as such has filed briefs *amicus curiae* in this case in the Tax Court and United States Court of Appeals for the Ninth Circuit. Clay Brown and the other respondents sold to the Institute the stock of Clay Brown & Company in the transaction which the Commissioner here seeks to characterize as something other than a sale. The tax character of this transaction is significantly involved in *West Los Angeles Institute for Cancer Research v. Commissioner*, Docket No. 94372, now pending in the Tax Court, where the tax exempt status of the Institute is at stake.

Introductory.

The opinions below, jurisdiction, question, statutes involved and statement are adequately presented in the petition for certiorari and respondents' brief in opposition. Accordingly, we will not repeat that material in this *amicus curiae* brief.

Reasons Against Granting the Writ.

The Commissioner wants this Court to grant certiorari and redefine, or perhaps more accurately, undefine, the word "sale" for federal tax purposes.

Particularly, the Commissioner says that "sale," as used in Section 1222(3) of the Internal Revenue Code of 1954, should be interpreted to exclude a "bootstrap" sale, for the purposes of determining capital gain. However, the burden of the petition is not that there is a specific conflict with the decision below by any other decision,[1] but rather that the administration of the income tax law is hampered by an unduly legalistic concept of "sale."

This case presents a study in the increasingly prevalent administrative process whereby commercial transactions made in reliance upon an apparently obvi-

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[1]The decision below is in accord with *Union Bank v. United States*, 285 F. 2d 126 (Ct. Cl. 1961), involving parallel facts, with the decision upon somewhat similar facts in *Commissioner v. Johnson*, 267 F. 2d 382 (C. A. 1, 1959), affirming *Estate of Ernest G. Howes v. Commissioner*, 30 T. C. 909 (1958), and with a number of Tax Court decisions, which are cited in the petition and brief in opposition. *Emanuel N. Kolkey v. Commissioner*, 254 F. 2d 51 (C. A. 7, 1958), affirming 27 T. C. 37 involved an ephemeral corporation that was established solely to make the purchase, was always controlled by the sellers through a staggering note issue which they owned, and was wholly reacquired by the sellers before the end of its first fiscal period; it is clearly distinguishable from the present situation of purchase by an independent entity unrelated to the sellers.

ous application of the tax statutes, are *ex post facto* reinterpreted by the Commissioner to involve an alleged "substance" and tax law impact that violates the original understanding of the parties. Frequently, the Government attack is mounted on a large scale, using the resources of its many offices, its access to courts around the nation, and its unlimited financial resources, in a display of power which the taxpayer cannot match and the defense against which calls for a frightening outlay of time, effort and expense. This process can be well-nigh ruinous in some cases; it has already caused reorganization of and severe hardship upon the Institute, as explained in its brief *amicus curiae* to the Ninth Circuit Court of Appeals (pp. 21-22); it should go no farther.

The most extreme application of this process occurs when Congress has enacted particular remedial legislation at the Commissioner's request, and parties have entered into a transaction in conformance with the remedial statute, but the Commissioner, still dissatisfied, decides in retrospect upon some ground of "substantive" reinterpretation that not only is at variance with the intention of the parties but also stultifies the remedy provided by Congress. This has happened here.

The remedial legislation was the 1950 amendments to the provisions of the Internal Revenue Code concerning exempt organizations and their participation in business activities; the amendments are described beginning at page 26 of the petition, and at pages 13 and subsequent of our brief *amicus curiae* to the Ninth Circuit. It is apparent from the Committee Reports there referred to that Congress was primarily concerned with the tax advantage enjoyed by a business owner who

made a "bootstrap" sale of the business to a foundation which, while risking no down payment or personal liability, thereupon used tax exempt income from the business to pay the purchase price. A detailed statutory remedy was provided by Congress; generally speaking, it removed the tax exemption for business operating income, and taxed to the foundation rental paid by an operating lessee for real and personal property according to a formula; no tax on rent from a lease up to five years; rent to be otherwise taxable in the proportion of financed purchase price to depreciated cost of the property.

Congress did not provide that a "bootstrap" sale should be treated as no sale. Conversely, if after all these years the Court were to so hold, what Congress did provide in 1950 would have been largely unnecessary.

The Institute, in specific reliance upon the 1950 amendments, purchased two businesses and leased for five years the real and personal properties obtained; the first of these transactions occurred in 1951; the second, the one now before the Court, in 1953.

The Commissioner's retroactive attack upon these transactions began with Rev. Rul. 54-420, 1954-2 Cum. Bull. 128, issued in the fall of 1954. For the Commissioner, the process of substantive reinterpretation by afterthought is a happy one, since his procedure is to merely challenge a transaction as being substantively not what the parties intended. Note the lack of reason or authority in Rev. Rul. 54-420. He may then reformulate his theory from time to time, according to his experience administratively and in the courts. Note the metamorphosis of the Commissioner's "theory" in this case

through his briefs in the Tax Court and Ninth Circuit to the petition here.

By contrast, the Institute and sellers to it have gone through ten dismal years of administrative and court proceedings in forum after forum, in which the Commissioner has refused, for vague and ever-changing reasons, to accept as a sale a transaction that was clearly a sale in law and in the understanding of the parties who negotiated it at arm's length and in good faith.

We are unable to comprehend the suggestion that this transaction was tailored to circumvent the 1950 amendments. (Petition, p. 29.) The agreements here provided that the fixed price be paid by the Institute out of a percentage of rental collected, but with minimum fixed biennial installments; under the five-year lease granted by the Institute, rents were contingent upon income but again were payable in fixed minimum biennial installments; in providing for contingent rents (versions of which are commercially common) and for a rate of price payment geared to rent collection, the parties here made an arrangement anticipated and regulated by Congress. Congress laid down specific requirements for use of tax exempt rental income for purchase of business property; the transaction in issue was designed to meet those requirements, not circumvent them.

The purpose was worthy. The Institute, which was entirely unrelated to Clay Brown, wanted to acquire his property in order to have resources for cancer research.

If this purpose or the means employed are unworthy in the Commissioner's eyes, he should return to Congress. He should not continue harassment of the Institute and sellers to it by protracting this litigation.

The petition (pp. 7 and subsequent) contends generally that a "bootstrap" sale makes no economic sense because the price is dictated by the seller solely to serve his tax purposes; therefore, it should not be treated as a "sale" providing capital gain.

Consider the business owner who is nearing retirement and decides to sell his business to key employees; the alternatives being to liquidate it, thereby throwing people out of work, or to merge it into a large corporation, thereby contributing to the disappearance of small business. Typically, the key employees have little if any down payment to spare and are unwilling to incur significant indebtedness (indeed, in California, where the Institute resides, purchasers are not expected to incur personal liability for purchase money debt).[2] It will take some years for these employees to pay the price in installments out of earnings of the business; they can be expected to agree to more than an all-cash price, but not to an unconscionable price that would too long defer their unencumbered ownership and enjoyment. Once the deal is made, the buyers will cling to "their" business; and woe betide the seller who may think he still owns it. Would it be the Commissioner's position, after the many decades that such a transaction clearly has been a "sale" for income tax purposes, that it is now to be classified as something else by Supreme Court decision? One can well imagine the chaos of uncertainty that would result from such a holding; some of which the Commissioner has foreseen and been frank enough to acknowledge. (Petition, pp. 22-23 and footnote 29.)

[2]In California, even in absence of a contract provision, there is no personal liability on purchase money debt for real and personal property (C. C. P. §§ 726 and 580(b)); in Oregon there is none on purchase money debt for real property (O. R. S. 88.070).

We trust that the Court will turn a deaf ear to the Commissioner's plea that the word "sale" shall no longer have a generally understood meaning, but shall join the word "debt"[3] and other words and concepts which have, for tax purposes, such meaning as the Commissioner may assign to them by afterthought.

Dealing at arm's length with unrelated parties, the Institute bought the stock of Clay Brown & Company, dissolved the corporation, and leased its assets to Fortuna Sawmills, Inc. The parties expected the price to be paid from rent. The Institute would have prevented foreclosure by independent financing if that had been warranted by the value of the property. It was only because of unexpectedly drastic adversity in the lumber business at the Fortuna location that the property had to be sold by the Institute to the State of California for its salvage value. In spite of this unexpected deterioration and default, the sellers were unwilling to face the problems of foreclosure and never did foreclose.

Substantially, this is the picture of a deferred payment sale and purchase of property. It does not lie with the Commissioner, who was not a party to a transaction of such legal and economic significance, later to interpret it in manner suitable only to himself.

There is no reason in justice or the Court's practice for granting certiorari in this case. The petition should be denied.

May 1964.

Respectfully submitted,

ARTHUR A. ARMSTRONG,
Attorney at Law.

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[3]See, *e.g.*, 4 Mertens Law of Federal Income Taxation 26.10 and subsequent.

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 17–81) is reported at 37 T.C. 461. The opinion of the court of appeals (R. 291–296) is reported at 325 F. 2d 313.

JURISDICTION

The judgments of the court of appeals were entered on December 10, 1963 (R. 296–299). By orders dated March 11, 1964, and April 3, 1964, Mr. Justice Douglas extended the time for filing a petition for certiorari to and including April 24, 1964 (R. 299). The petition

for certiorari was filed on April 24, 1964, and was granted on June 8, 1964 (R. 300; 377 U.S. 962). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a transfer of stock in which the transferor receives nothing but (1) a right to have remitted to him, until he has received a stated amount, whatever income accrues to the transferee from the ownership of the stock (or the underlying corporate assets), and (2) a right to recover the stock (or the assets) if the stated amount has not been remitted by a prescribed date, is a "sale" of the stock within the meaning of § 1222(3) of the Internal Revenue Code of 1954 (and § 117(a)(4) of the 1939 Code), entitling the transferor to report the income thereafter remitted to him only as long-term capital gain, or is a transfer of the stock with a retained income interest, making the remitted income taxable to the transferor as ordinary income.

STATUTE INVOLVED

Section 1222(3) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.) [1] provides that:

> The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

STATEMENT

This case involves deficiencies in personal income taxes asserted by the Commissioner of Internal Reve-

[1] § 117(a)(4) of the 1939 Code (26 U.S.C., 1952 ed.) is identical.

nue against the respondent taxpayers variously for the calendar years 1953, 1954, 1955, and 1956 (R. 97–98). In each instance the question is whether items of income received in those years by some or all of the taxpayers as a result of a transaction described below should have been reported and taxed as ordinary income, as the Commissioner asserts, or as long term capital gain, as the taxpayers maintain. The Tax Court, with six judges dissenting, disallowed the asserted deficiencies (R. 17–81). Its determination was affirmed by the Court of Appeals for the Ninth Circuit (R. 291–296). The Tax Court made extensive Findings of Fact (R. 20–58), some of which describe or paraphrase documents introduced by stipulation between the parties. The central documents are reproduced in the record (R. 161–287).

A. BACKGROUND AND GENERAL DESCRIPTION OF THE TRANSACTION

1. In 1952, Clay B. Brown was President of Clay Brown & Company (the "Corporation"), a corporation engaged in lumber milling. He, his wife Dorothy, his sons Donald and Philip, and his daughter Marilyn (all taxpayers and respondents herein), each owned 6,000 shares of the stock of the Corporation, aggregating 30,000 of its outstanding 32,000 shares of stock. Donald Brown was Assistant Vice President of the Corporation. Charles W. Booth was Secretary-Treasurer of the Corporation, and he and his wife Nancy (taxpayers and respondents herein) owned an aggregate of 1,500 shares of the stock of the Corporation. The remaining 500 shares were owned by C. A. Hill,

Vice President of the Corporation. Mr. Hill, as a stockholder of the Corporation, participated in the transactions hereafter described, but is not a party to this litigation (R. 21).

The Corporation had been formed in 1946, at which time each of the above listed members of the Brown family acquired 6,000 shares of its stock at a cost of $1 per share. Prior to 1950, the Corporation operated solely as a commission broker in the sale of lumber products produced by others. In the latter part of 1949, however, it acquired a log supply and a tract of land near Fortuna, California, and constructed a sawmill (Ex. 21–U, R. 163–164). The mill was put into operation during February, 1950, and an additional unit was added in 1951. (R. 21.) The sales and executive offices of the Corporation were maintained in Portland, Oregon, where Clay D. Brown and his wife resided; a sales office was also maintained in San Francisco (R. 95, 98–99). At the close of its fiscal year ending April 30, 1952, the Corporation's net worth was $397,782.10 (Ex. 21–U, R. 167). Its net income for that fiscal year, before federal income taxes, was $144,472.05; its after-tax income, $77,078.33 (Ex. 21–U, R. 161).

2. In October or November, 1952, after exploratory inquiries, a member of an investment firm brought Clay B. Brown together with Louis H. Seagrave, the chairman of the board of directors of the California Institute for Cancer Research (the "Institute"),[2] a

[2] The Institute's name was later changed to the West Los Angeles Institute for Cancer Research (R. 23).

tax-exempt charitable organization. The Institute was interested in becoming the owner of closely held businesses in accordance with procedures set forth in a brochure (Ex. 24–X, R. 170–179) prepared by Seagrave in consultation with an attorney for another tax-exempt organization in Los Angeles, a copy of which was furnished to Brown. (R. 24). The brochure outlined the mechanics of such a transaction—which was in the form of a sale of stock to the Institute—and described its advantages to the owners of a business (R. 172–173):

> Many owners of a closely held, successful business find it difficult to get any considerable part of the corporate profits into their personal possession, after providing for both corporate and personal federal and state income taxes.
>
> Working with the California Institute for Cancer Research, we have been able to solve this problem for a number of owners of sound concerns, having a strong current position, and valuable fixed assets consisting of land, buildings and operating equipment, achieving the following for the sellers:
>
> 1. They can sell their business to the Institute for more than they can sell for cash, for payment over a period of years, frequently with a substantial down payment [to be taken from the corporation's assets, R. 170].
>
> 2. They continue to control the business operation and to draw their regular salary, and retain an interest in the profits as well, until they are ready to retire.
>
> 3. They pay only a long term capital gains tax (26% federal).

* * * * *

> 5. They avoid the perplexing predicament of either paying prohibitively high personal taxes on distributed corporate earnings, or risking heavy penalties under Section 102 [1939 Code] for unreasonable accumulation of surplus if earnings are not distributed.

With Brown's expression of interest in such a transaction, there followed lengthy negotiations, conducted at arm's length with the participation of both lawyers and accountants, which ultimately resulted, on February 4, 1953, in a "sale" of all of the stock of the Corporation to the Institute in accordance with the procedure set forth in the brochure (R. 29–39).

The documentation of the transaction was intricate and will be described in more detail below, but its principal operative features were relatively simple. The stockholders conveyed their stock to the Institute; the Institute liquidated the Corporation and transferred its assets to a new operating company (the stock of which was owned by Brown's attorneys); and the operating company, employing Brown as general manager, continued to carry on the business with no change in the method of operation. In return, the operating company was to pay over to the Institute, as "rent" for the use of the properties, 80% of its net profits before taxes or depreciation. The Institute was to remit 90% of the amounts it received to the stockholders, as payments of the "purchase price" for the stock, until the sum remitted aggregated $1,300,000, whereupon the stockholders' interest was to terminate and the Institute was to have the complete beneficial ownership of the business. If the remittances to the stockholders fell behind a pre-

scribed schedule (at least $250,000 every two years), the stockholders could "foreclose" on the properties for payment of the remaining amount, but the Institute was to have no personal liability beyond its agreement to remit 90% of whatever it received from the operating company. In brief, the stockholders conveyed their stock to the Institute in exchange for (1) a right to 72% (90% of 80%) of the net profits of the business until they had received $1,300,000, and (2) a right to recover the properties (or a share of their proceeds) if the remittances fell behind a prescribed schedule (R. 37–42).

The tax advantages which were to compensate the stockholders for the ultimate loss of the business were considered at length in an 11-page memorandum submitted to Brown by his attorneys (Ex. 58–FFF, R. 264–274). The tax advantages there explored—and which were acknowledged to be what "makes the proposal of the Institute possible" (R. 270)—were two-fold:

> (1) the deduction of the "rents" by the operating company combined with the Institute's tax exemption would eliminate any corporate taxes on the business earnings, thereby substantially doubling the amount of business income available for distribution (with the corporate income taxes otherwise applicable being at a rate in excess of 50%) (see R. 270–273); and
>
> (2) with the transaction taking the form of a sale of the stock, the remittance to the stockholders of those enhanced amounts of earnings would be subject only to the very favorable long-term capital gains rates of tax, rather than to the much higher rates on ordinary income nor-

mally applicable to distributions of corporate earnings (see R. 266–269).

The attorneys noted that the treatment of the transaction as a "sale" of the stock was the feature "of primary importance to you" (R. 266) and cautioned Brown that "The more the deal is a straight sale of the stock * * *, the better your tax position" (R. 268).

B. THE DETAILS OF THE TRANSACTION

While the details of the transaction and the terminology employed in the complex set of documents by which the transaction was consummated have little significance in the view we take of the case, the nature of the instruments and their characterization for State law purposes seemed significant to the courts below and will presumably be relied upon by respondents. To give the Court the full flavor of the transaction in those terms, therefore, it is appropriate that we set out the documents and explain the effect of each in some detail.

1. All of the steps of the transaction, and all of the other documents to be executed, were set forth in a "Purchase Agreement" dated February 4, 1953 (Ex. 32–FF, R. 197–206). With a single exception to be noted, all of the other documents were also executed as of the same date (R. 37–40). Preparatory to the transaction, a new corporation, Fortuna Sawmills, Inc. ("Fortuna"), was formed to serve as the operating company. All of its $25,000 in capital stock was owned by two members of the law firm which represented Mr. Brown and the Corporation, and they, with a third member of the firm, became the officers and directors of the new corporation

(R. 104). Then, under date of February 4, 1953, and as provided for in the "Purchase Agreement," the following steps occurred:

a. The stockholders transferred to the Institute all their stock in the Corporation (R. 37).[3]

b. A newly installed board of directors caused the Corporation to be liquidated and all its assets to be transferred to the Institute (R. 39–40, 101–103; Exs. 33–GG through 43–QQ, not reproduced in the printed record).

c. The Institute paid over to the stockholders $5,000 in cash from the assets received from the Corporation (R. 37–38).

d. The Institute transferred all of the remaining assets to Fortuna. That was done under two separate instruments:

> (1) The land, buildings, equipment, and other fixed assets were transferred to Fortuna under a "Lease and License Agreement" with a five-year term (Ex. 49–WW, R. 215–216). As "rent," Fortuna agreed to pay to the Institute at semi-annual intervals an amount equal to 80% of its "net profits before depreciation, income, franchise, excess profits or other similar federal or states taxes" (R. 216). Fortuna was required to employ Clay B. Brown as General Manager (R. 222) and agreed to "exert its best efforts at all times to cause the demised premises to be pro-

[3] Notes against the Corporation in the amount of $125,000, held by Clay Brown and his wife, were also conveyed and cancelled as part of the transaction (R. 37). The difference between the notes and the stock is not material for present purposes, however, and for simplicity we will hereafter treat the transaction as involving only stock.

ductive of the highest possible net profits consistent with good business judgment and sound and economical operations" (R. 217). Fortuna was to maintain the property, pay the insurance premiums and taxes, and bear any operating losses (R. 216–219). Until the claims of the former stockholders were satisfied, the "Lease" could not be amended without the consent of Clay Brown, and should Mr. Brown be unable or unwilling to act as General Manager his successor was to be approved by the majority in interest of the former stockholders (R. 222). [If the stockholders' claims were not satisfied by the end of the five-year term, it was contemplated that a new lease would be made with the same or a different corporate entity (see R. 26–27).]

(2) The current assets of the old Corporation (cash, bank accounts, inventory, accounts receivable, *etc.*) were transferred to Fortuna by a "General Assignment to Fortuna Sawmills, Inc." (Ex. 50–XX, R. 235–236). In exchange, Fortuna executed an "Assumption Agreement of Fortuna Sawmills, Inc.," whereby it assumed all the debts of the old Corporation and agreed to give the Institute a "Promissory Note", payable without interest at the end of the lease, for the amount by which the book value of the current assets exceeded the debts assumed (Ex. 51–YY, R. 237–238). That excess was later determined by an audit to be $20,991, and in due course (on May 15, 1953) Fortuna executed the required note in that amount (Ex. 52–ZZ, R. 239–240).

e. In exchange for the stock of the Corporation, the Institute gave the stockholders a noninterest-bearing "Promissory Note" for $1,300,000 which was expressly stated to be non-negotiable (Ex. 44–RR,

R. 211–213). By the terms of the "note," the Institute agreed to pay $5,000 forthwith upon the liquidation of the Corporation (see paragraph *c*, above) and thereafter to pay, within five days of receipt, 90% of "all royalties or rents received in cash" from the lease of the assets to Fortuna (see paragraph *d*, above) or any substitute lease. The Institute had the right, but no obligation, to make payments from other sources. The entire balance of the note was to "become due and payable on" January 1, 1963, but the stockholders could accelerate payment if the payments were less than $250,000 in any two-year period. Upon any default in payment, the stockholders' sole recourse was against the security given for the note (see paragraph *f*, following).[4]

f. As security for the "Promissory Note" given the stockholders, the Institute executed (R. 103–104):

> (1) a "Deed of Trust" and a "Chattel Mortgage" covering all the fixed assets received by it on the liquidation of the Corporation and leased to Fortuna (Exs. 45–SS and 46–TT, not reproduced in the printed record);[5] and

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[4] The "Promissory Note" expressly incorporated the terms of the "Purchase Agreement" for the detailed definition of the Institute's obligations (R. 211–212). The limitation of the Institute's liability to the remitting of 90% of the amounts received from Fortuna, implicit on the face of the note, is made explicit in paragraphs VI and VIII of that agreement (Ex. 32–FF, R. 200).

[5] Those instruments in terms obligated the Institute to pay for insurance premiums, taxes, maintenance and repairs on the mortgaged property (undertakings which Fortuna also made to the Institute), but the stockholders furnished the Institute a letter assuring it that they would "never attempt to enforce * * * said provisions against your Institute personally"

(2) a "General Assignment" of (a) the note to be given it by Fortuna for the current assets and (b) 90% of the rent to be paid by Fortuna under the lease of the fixed assets (Ex. 47–UU, R. 213–215).

2. Omitting the procedural steps and the characterizations used by the parties, the overall effect of the transaction may be simply stated. Except for the $5,000 in cash withdrawn and given to the stockholders, all of the assets of the old Corporation were transferred as a going business to a new corporation which, employing the same personnel, continued to operate the enterprise in exactly the same fashion as it had been operated before. The only difference was that the net earnings of the business (before income taxes or depreciation) were now to be distributed 8% to the Institute and 72% to the former stockholders. If the amounts distributed to the stockholders aggregated $1,300,000 within a ten-year period, their interest in the business was to terminate, and the Institute would then have complete beneficial ownership of the business and its assets. Otherwise (unless the Institute chose to volunteer payment from other sources), the stockholders were entitled to recover the properties (or a share of their proceeds) and terminate the Institute's interest.

What the stockholders hoped to gain by the transaction, we have already shown (enhanced distributions of business earnings, undiminished by corporate

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and that any default "shall entitle the [stockholders] only to proceed with foreclosure proceedings" against the pledged property (Ex. 83–EEE, not reproduced in the printed record; see R. 44–47, 112).

taxes, which would be taxable to them only as capital gains). What the Institute hoped to gain was the 8% of the business earnings to be distributed to it currently plus, ultimately, the full ownership of the business. Its hope of receiving the assets might or might not ever materialize, but beyond the failure of its hopes it could lose nothing. From its own resources, it was to pay, and paid, nothing; it was to risk, and risked, nothing.

C. EVENTS FOLLOWING THE TRANSACTION

1. Following the transaction, the business continued in operation as before, on the same premises, with the same personnel, and under the same management (Clay Brown being paid as General Manager of Fortuna the same salary he had previously received from the Corporation, $25,000 per year) (Ex. 53-AAA, R. 240-241; R. 26, 44, 47). Fortuna borrowed money to meet its current needs from the same bank that had previously financed the Corporation, and Clay Brown personally guaranteed one of its loans in the amount of $50,000 (R. 49).*

* Clay Brown resigned as general manager as of October 31, 1954, but he continued to serve "in an advisory capacity" with a salary of $12,000 and with authority to sign corporate checks (R. 48). The directors resolved not to appoint a successor as general manager since, with Mr. Brown remaining available in an advisory capacity and with Messrs. Booth and Hill already overseeing the Portland office and the mill, none was needed (R. 130, 132-133). Clay Brown continued his periodic visits to the mill and his voice seems to have continued to be dominant one, whatever his formal capacity (R. 130-133). Whether his resignation was precipitated by the advice of tax counsel is unclear (see R. 49; Ex. 57-EEE, R. 257-258, 262).

2. During the period from February 4, 1953, through April 30, 1956, Fortuna made semi-annual payments to the Institute of 80% of its net profits, and the Institute remitted 90% of those payments to the former stockholders. As of the end of the fiscal year ending April 30, 1956, payments from Fortuna to the Institute had amounted to $716,622, and the Institute had remitted $651,094 to the stockholders (R. 56; Ex. 73-UUU, R. 275–277).

Beginning in November 1956, Fortuna suffered heavy losses (over $125,000 in the six-month period ending April 30, 1957) as a result of a decline of lumber prices and a change in freight rates, and in June 1957 the mill was shut down (R. 50). A series of disagreements then developed between the Institute and both the former stockholders and Fortuna, but they were ultimately resolved by a further agreement (R. 54). In 1958, pursuant to the agreement, the mill properties were sold to the highway department of the State of California for $300,000 and the net proceeds were divided 10% to the Institute and 90% to the stockholders, whereupon the relationship between the Institute and the former stockholders was terminated (R. 54–55). These last payments are not involved in the present litigation, since 1956 is the most recent taxable year at issue.

D. THE PROCEEDINGS BELOW

Using the installment method, each respondent offset a proportionate part of his basis in the stock against the amounts remitted to him each year by the Institute and reported the net gain as long-term capi-

tal gain. The Commissioner of Internal Revenue held that the transaction was not a "sale" within the meaning of § 1222(3) of the Internal Revenue Code of 1954[7] and that the gains for the years 1953-1956 were taxable as ordinary income, determining deficiencies accordingly (R. 57).

The full Tax Court (R. 57–72), with six judges dissenting (R. 72–81), held the transaction a "sale" and the gains taxable only as capital gains. The court noted that "It may be * * * that [respondents] would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," but said that a taxpayer has the right "to increase the amount received from a transaction over what he might have received from a different transaction" and that a sale is not to be ignored "solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay" (R. 62).[8]

The court of appeals affirmed (R. 291–296). Although acknowledging that the transaction took the form it did because the Institute was tax-exempt and that "the price to be paid was probably greater for

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[7] The first year involved is governed by the 1939 Code, § 117 (a)(4) of which is identical, but for convenience all section references in this brief will, unless otherwise indicated, be to the 1954 Code.

[8] The price was, moreover, a "result of real negotiating" and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth" (R. 64), confirming that the Institute acted at arm's length with a real expectation that the earnings would be sufficient to permit full payment and that there was no "tacit understanding" that the transaction would collapse, permitting respondents to recover possession (R. 63–64, 36).

that reason" (R. 295), it held that the transaction was a "genuine sale" because there was a transfer of title, of permanent ownership, of the benefit of part of the current income, and of the operation of the business (R. 294–295).

SUMMARY OF ARGUMENT

I

Despite the complexity of the transaction, the issue in this case can be reduced to very simple terms: Is a transfer of stock in which the transferor receives nothing but (1) a right to have the dividends remitted to him until he has received a stated sum, and (2) a right to recover the stock (or a share of its proceeds) if the stated amount has not been remitted by a prescribed date, a "sale" of the stock within the meaning of the capital-gain provisions, entitling the transferor to account for the dividends thereafter remitted only as capital gains? While the actual transaction included some further steps the purpose of which was to eliminate the corporation income tax and thus increase the yield to be remitted to the respondents—to wit, the Institute's liquidation of the corporation and transfer of its assets to Fortuna—those further steps have no bearing on the issue in this case: was the initial transfer of the stock to the Institute a "sale"? That question would be exactly the same if the corporation had not been liquidated and the Institute's obligation to remit the income had been defined in terms of the dividends to be paid by the old corporation rather than in terms of the yield from liquidating the corporation and "leasing" its assets. For simplicity of analysis, therefore, we may assume that the

corporation was not liquidated, that the Institute's obligation was to remit 90% of the dividends received from the corporation, and that the respondents' rights of recourse if the remittances fell behind schedule were against the stock itself.

II

Analyzed in economic terms, a transaction in which *A* transfers stock to *B* solely for *B*'s promise to remit the dividends up to a stated amount, with *A* having the right to recover the stock (or a share of its proceeds) if the amount has not been remitted by a certain time, makes no sense. Since *A* was previously entitled to receive all the dividends without limit yet retain full ownership of the stock, the transaction gives him nothing he did not have before and amounts simply to the voluntary imposition by him of a limit on his previously unlimited rights. If donatively motivated, such a transaction would plainly be but a conditional gift by *A* to *B* of a future interest in the stock, to become possessory if, by a prescribed date, the dividends remitted should reach a stated amount. If the transaction is concluded between parties negotiating at arm's-length with each other—as it is agreed this transaction was—the terms are necessarily arbitrary, since *B*, contributing nothing, has nothing to bargain about. The only explanation of such a transaction is the hoped-for tax benefit—namely, the hope that it will be treated as a "sale" and cause the dividends subsequently remitted to *A* to be taxed only as capital gains, an advantage which, if the amounts to be remitted are sufficiently greater than the presently-realizable value of the stock, will more than

make up for *A*'s ultimate surrender of the stock. Since no reasonable man moved only by economic considerations independent of taxes would agree to such a transaction with a stranger however great the stated amount of dividends to be remitted might be, and since the stated amount must be substantially greater than the present value of the stock for the transaction to yield even a tax advantage, it must be presumed that the amount agreed upon in such a transaction between strangers is in fact—as the courts below acknowledged it probably was here—substantially greater than the value of the stock at the time of the transaction. And if the stated amount is greater than the present value of the stock, it is evident that *A* not only continues to bear the full risk of future losses but also will receive, up to the self-imposed limitation, the benefit of any future gains or profits.

That does not mean, however, that the transaction lacks "substance" or is a "sham," for it does have some very real substantive consequences. Not only is there an immediate transfer of legal ownership—and with it, for example, the voting rights in the stock—but there is the very real possibility that the stock will "buy itself out" and *B* will end up with the full beneficial ownership. The question, then, is not whether the transaction has "substance" but whether its substance is that of a "sale" or—as we contend it is—that of a transfer with a retained income interest.

III

The basic difference between sales and reserved-income transfers, we submit, is that in sales the pri-

mary burden of future losses and the full benefit of future gains and profits are shifted to the transferee, while in reserved-income transfers the transferor remains dependent for payment upon, and thus shares in, the future gains and profits from the property. If so, it follows that the transaction in this case—in which neither the risk nor the benefits of future gains or losses were shifted—is not a sale.

That a transfer of stock solely on the transferee's promise to remit the dividends for a time or up to a stated amount is not a "sale" is established not only by the lower court decisions but by this Court's decisions holding that a transfer of mineral interests on the transferee's promise to remit a stated amount out of any oil produced is not a sale. And as those cases show, the question turns, not upon the passage of legal title, but solely upon the transferor's economic dependence upon the future production of income from the property.

A transfer of stock in exchange for a substantial down payment, the transferee's promise to remit the dividends up to a stated amount, and a right to recover the stock (or a share of its proceeds) if the stated amount has not been paid by a day certain is, on the other hand, equally plainly a sale. The difference is not in the labels used by the parties. Nor can it be that there is a transfer of ownership as a matter of property law, for that is equally true of transfers with a retained income interest. The difference is rather that the down payment leaves the stock as security for only a fraction of the purchase price, thereby giving the transferor a reasonable assurance

of payment independent of the future dividend yield and of at least substantial changes in the value of the stock. The primary risks of future losses and the benefit of future gains are thus shifted to the transferee. The result is a "conversion" of the transferor's former "equity" interest in the stock—bearing the risks and realizing the benefits of gains and losses—into a secured "creditor's" claim against it, and that in turn is what a "sale" is all about.

The transaction here differs from the clear case of a reserved-income transfer in that respondents also had the right, if the remittances fell behind a prescribed schedule, to cause the stock to be sold and to recover the balance due out of any proceeds. But if our analysis of the basic difference between sales and reserved-income transfers is correct, such a "foreclosure" right is relevant only to the extent that it does in fact afford reasonable assurance of payment independent of future gains or profits from the property. Since in this case the amount to be remitted must be presumed to have been substantially greater than the present value of the property—for there can be no other explanation of the transaction—the right of recourse against the property provided no assurance of payment. By the same token, respondents continued to share the benefits from any future gains or profits, since it was only from such gains or profits that they could be paid. There was thus no "conversion" of the respondents' interests, through risk-shifting, from an "equity" interest in the stock to a "creditor's" claim against it, and hence there was no

"sale." Respondents merely imposed a limit upon their previously unlimited rights to receive the future gains and profits from the property and thereby made a conditional gift to the Institute of a future interest in the property.

That treatment is required also by the declared purposes of the capital-gains provisions, which, as stated in the committee report, was to afford special treatment to the realization, by a sale, of "gains and profits earned over a series of years" *prior to the sale.* That purpose requires that capital-gains treatment be limited to amounts representing a realization upon the present value of the property at the time of the transaction. And to hold that this transaction was a sale would, as we have shown, result in according capital gains treatment to the respondents' receipt of the ordinary profits produced by the property after the transfer.

IV

Transactions in which the transferee contributes, either by making a further investment or by furnishing services, to the production of the income to be remitted to the transferor pose a different question, since the transferee's contribution may itself, at least in some situations, cause a significant shifting of the primary risks. The decision here ought, therefore, to be confined to transactions in which, as here, the transferee performs a purely passive role, merely collecting and remitting income to the production of which he has made no contribution.

V

If the transfer of the stock to the Institute was not a "sale," the questions that remain as to the effect upon respondents of the subsequent steps of the transaction (the liquidation of the corporation and the transfer of its assets to a new corporation) are not essentially different from those that would be presented if respondents had not purported to "sell" their stock to the Institute but had themselves liquidated the corporation and transferred the assets to Fortuna on the same terms. That transaction would present the questions, for example, whether the liquidation of the old corporation and the transfer of its assets to a new corporation qualified as a tax-free "reorganization" and whether, even if there was no reorganization, the "lease" of the assets to Fortuna for 80% of its net profits should, on "thin capitalization" principles, be treated as giving rise to an "equity" or "stock" interest in Fortuna, making the "rental" payments non-deductible "dividends." Those questions, however, are entirely separate from the question whether the initial transfer of the stock constituted a "sale"; no issue has yet been raised about them by the parties; and they have not been passed upon by the courts below. None of those questions is now before this Court, therefore, and the decision here should be confined to the "sale" question, leaving to the lower courts on remand the effect, if any, of the subsequent steps upon respondents if the initial step was not a sale of the stock.

ARGUMENT

INTRODUCTORY

The transaction in this case involves a highly-publicized and widely exploited device the primary objects of which are (1) to eliminate the corporation income tax on business earnings and (2) to cause the distribution of the earnings to the former stockholders to be taxed only as long-term capital gains.[9] The transaction requires the participation of a tax-exempt entity to whom the stockholders must suffer the ultimate ownership of their business to pass, but the tax savings are so great that the stockholders are more than compensated. The plan has been developed primarily by advisers to tax-exempt institutions, but so attractive is it to the owners of a closely-held business that a single institution[10] has been able to acquire 26 different businesses (at an average price of $1.3 million each) by that means. The principal deterrent to date against an even wider exploitation of the transaction has been the fear that the tax consequences upon

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[9] See Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. of Pa. L. Rev. 623 (1960); Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87 (1956); MacCracken, *Selling a Business to a Charitable Foundation*, 1954 U. of So. Calif. Tax Inst. 205; Comment, *The Three-Party Sale and Lease-Back*, 61 Mich. L. Rev. 1140 (1963); Alexander, *The Use of Foundations in Business*, 15 N.Y.U. Tax Inst. 591; *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963). See also Stern, *The Great Treasury Raid*, p. 245 (1964).

[10] The University Hill Foundation in Los Angeles, which was a participant, for example, in all of the cases cited in note 11, *infra*, and in the *Union Bank* case cited in note 13, *infra*. It was the attorney for the University Hill Foundation (which is associated with Loyola University) who aided Mr. Seagrave in preparing the brochure used by him (R. 24).

which it depends might be successfully challenged. But if the doubts are authoritatively resolved in favor of the transaction, there is no reason why any high-bracket owner of a business should continue to pay ordinary income taxes on its earnings. It is because of that sweeping importance of the question—even apart from its implications in other areas—that we sought certiorari in this case.[11]

Although the transaction may also raise some questions as to the tax treatment of the charity, its cornerstones are (1) the treatment of the stockholders' transfer of their stock as a "sale" (thereby giving them capital-gains treatment on their subsequent receipts); and (2) the deductibility of the earnings paid out by the operating company as "rent" (thereby eliminating the corporate tax and enhancing the amounts available for distribution to the former stockholders). In 1954, the Commissioner, launching an all-out attack on such transactions, ruled, *inter alia*, that the stock transfer was not a "sale" and that the remittances to the stockholders were taxable as ordinary income,[12] but his attack has met with only limited success in the lower courts. In the first case to be taken to a court of appeals, the facts were extreme and the court had

[11] Five additional cases from the Tax Court involving substantially identical transactions are now pending on appeal in the court below and are being held to await the decision of this case. *Anderson Dairy, Inc.* v. *Commissioner*, 39 T.C. 1027; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Singer* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,158; *Isis Windows, Inc.* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,176; *Stahl* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,201.

[12] Rev. Rul. 54-420, 1954-2 Cum. Bull. 128.

no difficulty in seeing through the form to the real nature of the transaction and accordingly held that it was not a "sale." *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7). Other taxpayers have been more careful, however, and by setting terms not so extreme as to make the device equally transparent—though in principle it remains the same—have persuaded other courts to explain away the *Kolkey* case as involving a "sham" transaction and to uphold their better camouflaged transactions as "sales."[13] The Commissioners' attack on the "rental" deduction has fared somewhat better, but has yet to meet with full success.[14]

This case is concerned only with whether the stockholders' receipts from such a transaction are to be accounted for as "capital gain." That term is defined simply as "gain from the sale or exchange of a capital asset". (§ 1222(3)).[15] There is here no dis-

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[13] *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1); *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cls.); *Knapp Brothers Shoe Mfg. Co.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.); cf. *Caldwell* v. *Campbell*, 218 F. 2d 567 (C.A. 5.) Of those, only the *Union Bank* case involved the same form of transaction used in this case. The *Johnson* and *Knapp Brothers* cases, like the *Kolkey* case itself, involved a variant of the transaction in use before the Revenue Act of 1950 (§ 301, 64 Stat. 948). The differences in the transactions, the effect of the Revenue Act of 1950, and why the transactions now take the indirect form they do, are explained in the petition (Pet. 26–30).

[14] Rental deduction disallowed: *Brekke* v. *Commissioner*, 40 T.C. 789. Rental deduction partially disallowed; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Estate of Goldenberg* v. *Commissioner*, 1964 P-H T.C. Mem. Dec. ¶ 64,134. Rental deductions allowed: *Anderson Dairy*, *Isis Windows*, and *Stahl*, cited in note 11, *supra*.

[15] That has been the definition ever since special treatment was first accorded to capital gains in the Revenue Act of 1921 (§ 206(a)(1), 42 Stat. 232).

pute that respondents' stock in the old corporation was a "capital asset" and there is no claim that there was a taxable "exchange" of properties. The sole question, then, is whether the respondents' transfer of their stock to the Institute, on the terms agreed upon, was a "sale" of the stock within the meaning of that provision.

That there is *something* wrong with a transaction for which such extraordinary tax benefits are claimed seems apparent. The difficulty lies in identifying precisely what is wrong. The fact that the transaction usually involves a closely-held corporation the stockholders of which are also the managers, and that the usual arrangement is for them to continue to manage the business after the stock transfer, may at first be thought to be the objectionable feature. Upon reflection, however, it is evident that essentially the same thing could be accomplished, with the same vice, with a passive investment involving no "management" features at all (*e.g.*, stock in a widely-held corporation). Nor does the primary vice seem to lie in an "abuse" of the charity's tax-exemption, for if the initial question, "Whose income is it?", is properly answered, there ought to be no objection to according the normal exemption to the income *properly* attributed to the charity. It is generally only when the tax law permits income to be taxed to someone other than the one who realizes the real benefit from it that the opportunity to "abuse" a tax exemption arises, and that is the case here.

What in our view is wrong with the claimed "sale" characterization is both more precise and more funda-

mental than those objections. The basic difference between sales and transfers of property with a retained income interest, we will show, is that in "sales" the primary burden of future losses and the full benefit of future gains and profits are shifted to the transferee, while in reserved-income transfers the transferor remains dependent for payment upon, and thus shares in, the *future* gains and profits from the property. And if that is so, this transaction was not a sale for the simple reason that the burdens and benefits of the future gains and losses were in no way shifted from the respondents to the Institute. The respondents retained not only the full risk of future losses but also a right to a share of the benefits from the future gains, and their realization upon those benefits must be taxed to them as ordinary income, not as the proceeds from a "sale" of their stock.

I

THIS CASE IS EQUIVALENT, FOR PURPOSES OF ANALYSIS, TO A TRANSFER OF STOCK IN WHICH THE TRANSFEROR RETAINS THE RIGHT TO THE DIVIDENDS UP TO A STATED AMOUNT AND THE FURTHER RIGHT TO RECOVER THE STOCK, OR A SHARE OF ITS PROCEEDS, IF THE STATED AMOUNT HAS NOT BEEN RECEIVED BY A PRESCRIBED DATE

The difficulty the lower courts have had in dealing with these transactions is attributable to a complexity that tends to obscure the basic nature of the transaction. Only a part of the transaction is actually relevant to the question presented here, however, and the rest of the transaction can be ignored for present purposes.

The transaction in this case may be divided into the following three steps:

(1) The stockholders transferred their stock to the Institute in exchange for a "note" for $1,300,000 under which the Institute's liability was limited to remitting to the stockholders 90% of any amounts received by it on account of its ownership of the stock. The stockholders were also given the right to "foreclose" on the stock (or its equivalent), to recover the balance remaining due, if they were paid less than $250,000 in any two-year period.

(2) The Institute liquidated the original corporation, the effect of which was to substitute the corporate assets for the stock both as the source of the Institute's income and as the security for payment of the "note."

(3) The Institute transferred the corporate assets to Fortuna for a "rental" equal to 80% of the net profits.

The sole function of the second and third steps (taking the assets out of the corporation and "leasing" them for "rent") was to eliminate the corporation income tax that would have been due if the original corporation had been continued in existence. It was hoped that, under the lease arrangement, the profits remitted by Fortuna to the Institute would be deductible as "rent" by it yet not be taxable as "unrelated business income" to the Institute, and thus never be subjected to a corporation income tax. The success or failure of those steps to achieve that end is not, however, our present concern. We are concerned only with the effect of the initial step of the transaction—to wit, whether the stockholders' transfer of

their stock to the Institute on the terms of payment agreed upon constituted a "sale" of the stock, entitling the stockholders to account for their subsequent receipts from the Institute as capital gains. If it is concluded that that step in the transaction was not a "sale", then the further steps may have some bearing on the proper treatment of the stockholders' subsequent receipts (see Point V), but they are not germane to the "sale" question itself and may be ignored in considering that question.

To the extent that the terms of the purported sale of the stock to the Institute anticipated and took into account the subsequent steps, it is of course necessary, in order to close off the transaction after the first step, to assume a modification of those terms to make them consistent with the continued existence of the corporation. We will assume, accordingly, the following version of the transaction: The stockholders transfer their stock to the Institute in exchange for "notes" for $1,300,000 under which the Institute's liability is limited to remitting 90% of any *dividends* paid on the stock. The stock is pledged to secure payment of the note, and the stockholders are entitled to foreclose if the payments are less than $250,000 in any two-year period. It is further agreed that the Institute, as sole stockholder, will cause the corporation to distribute as dividends each year 100% of its after-tax income[16] and to continue to employ Clay Brown as general manager.

[16] The increased percentage of the business income to be distributed to the Institute is designed to compensate, so far as possible, for the fact that in that simplified version of the transaction the business income would remain subject to, and be diminished by, a corporation income tax.

It is in terms of that simplified version of the transaction that the main argument in this brief will be cast. The minor modification of the terms necessary to eliminate the further steps does not change the basic nature of the initial transaction. If the stockholders would not be entitled to capital gains treatment of their proceeds from the simplified version of the transaction, they are surely no better off because they also found what they believed was a way to eliminate the corporation income tax as well.

II

THE TRANSACTION MAKES NO ECONOMIC SENSE AND THE AMOUNT OF INCOME TO BE REMITTED MUST BE GREATER THAN THE PRESENTLY-REALIZABLE VALUE OF THE STOCK FOR THE TRANSACTION TO YIELD EVEN THE HOPED-FOR TAX ADVANTAGE

It was found below and vigorously asserted by respondents (see Br. in Opp. 4–5) that the transaction was the result of arm's-length bargaining, and the record leaves no room for doubt that neither party was motivated by any purpose to benefit the other and that each party sought only to advance its own interests. To examine the economic substance of such a transaction between persons dealing at arm's length, we may take an even simpler example which eliminates both the feature of continuing control of a closely-held corporation and, initially at least, the use of the charitable exemption (features which we assume are, if anything, unfavorable to respondents).

1. Assume that *A* owns as a passive investment a minority stock interest in a widely-held corporation,

the stock of which is traded over-the-counter. The current market value of *A*'s stock is $500,000 and its current dividend yield is $100,000, but the business is a young one of a speculative nature and the future of the stock, both in value and in yield, is relatively uncertain. *B*, a stranger, offers to buy the stock from *A* on the following terms: *B* will make no down payment and will not be personally liable but will give *A* a "note" secured by the stock in whatever total amount the parties agree upon as the "purchase price"; the stock and the note will be held by an escrow agent who will collect the dividends and remit them to *A* as payments on the note until the note is fully paid; if the payments are ever less than $100,000 a year, *A* may declare the balance due and, upon default, require the stock to be sold and the proceeds to be applied on the note.

Assuming the parties are untutored in tax law and bargain solely in economic terms, what "purchase price" might they be expected to agree upon? $500,000, $1,000,000, or $5,000,000? The answer, obviously, is that *A* will not agree to sell on those terms at any price. He is already entitled to receive all the dividends on the stock without limit and still retain full ownership of the stock. *B* is offering him neither anything more nor anything different but is simply asking him to impose a limit on his previously unlimited rights both to the stock and to its yield and to make a gratuitous transfer of the residual interest. Since *B* is to furnish nothing and risk nothing, there is nothing to bargain about, and however high the

"price" might be set it would still be less than a "reasonable" one on the terms offered and *A* would still be surrendering the ultimate ownership of the stock to *B* for nothing. In short, the offer is wholly meaningless in economic terms; it is but a request by *B* that *A* make a gift to him of a "remainder" interest in the stock after a reservation by *A* of whatever part of the future dividends he chooses to reserve to himself.

But now suppose that *B* is a reader of tax journals and points out to *A* (as the Institute pointed out to respondents) that, if he enters into the transaction, his subsequent receipts of the remitted dividends, though no different in amount than if he had kept the stock, will be treated as payments of the "purchase price" on a "sale" of the stock and thus be taxable only as capital gains. Being, as we will assume, in the 80% tax bracket, *A* readily grasps that if he can cut his tax rate on his annual receipts to 25% he will be well ahead in a few years even if it should cost him the ultimate ownership of the stock. If the dividends proved sufficient to pay the "price," such a "sale" of the stock for $1,000,000 would, for example, yield him $750,000 after taxes, whereas he would have only $575,000 after taxes if he held the stock for that period, reported the dividends as ordinary income, and then sold the stock for $500,000 in cash."[11] With a "price" of $2,000,000 the comparative

[11] We are assuming that *A*'s basis in the stock—often, as here, quite low—is zero. The after-tax yield from $1,000,000 of dividends taxable as ordinary income at an 80% rate would be $200,000; the yield from $500,000 of capital gains (from

after-tax yields would be $1,500,000 from the sale to *B* and $775,000 from a retention and subsequent cash sale.

With the parties having explored the tax advantages, what "price" might they now be expected to arrive at in their arm's-length "bargaining"? Since anyone else would serve *A*'s tax purposes as well as *B*, *B* still has no bargaining position—unless it be his "moral" claim to a share of the benefits as the "promoter" of the deal. Yet *A* is soon persuaded by the advice of the tax commentators [18] that the price should not be set too high lest the device, like that in *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7), be made transparent, and the same note of caution might also dissuade him from giving the windfall to, say, his son rather than to a stranger. On the other hand, the price must, as the commentators recognize,[19] be considerably greater than $500,000 to give *A* any benefit at all, since he could sell the stock over-the-counter for that price, be relieved of any further risk, and be entitled to capital-gains treatment without question. With those considerations providing the content for the so-called "bargaining"—and respondents, despite

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the sale at the end of the period) would be $375,000. If the amounts and rates used seem rather extreme, it only reflects the fact that, unless the "price" is set transparently high, the transaction is not generally feasible without also finding a way to eliminate the corporation tax and thus increase the annual cash yield.

[18] See articles cited in note 9, *supra*.

[19] See, *e.g.*, Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87, 100: "An abnormally high purchase price is economically essential to the transaction * * *."

their repeated assertions of the bargained nature of the transaction, have yet to say what other content there could be—we can only suppose that *A* would temper avarice with caution and somehow arrive at a "price" very considerably greater than the market price but not so much greater as to expose the transaction for what it is.

There is, however, a complication. A necessary corollary of *A*'s claim that the remitted dividends are payments of a "purchase price" to him for the "sale" of his stock would be that the dividends were taxable as ordinary income to *B*, applied by him to "purchase" the stock. While the difference in their tax brackets might still leave some room for maneuvering, that consequence would not only seriously diminish the over-all tax advantages but might also focus attention on the anomaly of taxing *B* on dividends which he merely collects and remits to *A* and which will total an amount far greater than any real economic benefit he receives (simply the possibility of the ultimate ownership of stock worth much less than the remitted-dividend "price"). It is for that reason that, as a practical matter, it becomes essential to use a tax-exempt entity as the "buyer" in such transactions. The tax exemption not only shields the dividends from any tax in the purchaser's hands but also obscures the anomalous implications of taxing the dividends to someone who merely collects and remits them to *A*.

The contribution that the use of the tax exemption makes to the transaction might, of course, be thought to give a tax-exempt "buyer" somewhat more bargaining power than an individual buyer would have. But

even that content of the "bargaining" is more illusory than real, since there are an almost unlimited number of possible tax-exempt buyers and it requires, indeed, only a certificate of incorporation for *A* to create one of his own. Such "bargaining" power as a tax-exempt buyer has must come, rather, only (1) from the facade of respectability which the participation of an established and well-reputed institution gives to the transaction and (2) from the "moral" claim that the initiating institution may be thought to have to share in the benefits from the plan which it worked out and first brought to *A*'s attention (see R. 173–174).

2. Pursuing the economic analysis of that transaction further, it is apparent that, if the price is anything more than $500,000, *A* can receive full payment, if at all, only by participating in the benefits of the *future* dividend yield or capital appreciation of the stock. His right of recourse against the stock itself affords him no assurance of payment, since by hypothesis its realizable cash value at the time of the "sale" is only $500,000. He thus not only continues to bear the full risk of loss from any future depreciation in the value of the stock but also to share in the benefits from any future income. His investment, in short, remains fully subject to exactly the same risks to which it was exposed before the transaction. What has been limited is not the risks to which the investment is exposed but only the benefits that will accrue to *A* should the investment turn out well.

Even if the price were set at $500,000—a price that could be explained only by *A*'s being truly motivated by charitable impulses—*A*'s receipt of that

amount would still remain fully subject to the risk of any future losses, and he would simply have eschewed any benefit from the future gains. While *A* would, it is true, have a right of recourse against stock that was initially worth that amount, he would have no margin of protection against fluctuations in the value of the stock and would thus bear the full burden of any future depreciation in its value.

There would be a significant change in the nature of the risk borne by *A* only if the price were in fact set at an amount substantially *less* than $500,000, in which event his right of recourse against stock initially worth that amount would give him a substantial margin of protection against future losses and thus provide him with a reasonable assurance of payment of his reduced claim independent of the future income-productivity of the stock. Such a price, however (as, indeed, would a price of $500,000), would constitute a gift of a very substantial equity in the stock to *B* and would thus be wholly inconsistent with our assumption (and respondents' claim) that the transaction was one at arm's length and not donatively motivated.

3. What the foregoing analysis shows is that any "bargaining" in such a transaction is economically meaningless and that, if the transaction is between persons dealing at arm's length and is not donatively motivated, the "price" must be presumed to be substantially in excess of the currently-realizable cash value of the stock. That conclusion requires, indeed, neither more nor less than the usual presumption that the price at which a transaction is concluded

between parties dealing at arms length will be a "reasonable" one—that is to say, the price that reasonable men, *dealing on the same terms,* would agree upon. And a necessary consequence of the price being greater than the presently-realizable cash value of the stock is that *A* will not only bear the full risk of any future losses but will also share in the benefit of any future income production or capital appreciation. What he receives, therefore, will represent, not the proceeds from his "cashing in" on the values accrued in the past (*ie.,* the present value of the stock), but the proceeds of his continued risk-bearing participation in the future gains and losses.

That, however, is all that we mean to establish by the foregoing analysis. We do not mean to deny that the transaction has "substance" or that it is "real" and not a "sham," for it may indeed have many "real" consequences even apart from the technical passage of legal title. One consequence, for example, is that *B* will thereafter have the voting rights in the stock. By far the most important consequence, however, is that *B* not only has legal title but may (if the dividends prove sufficient to pay the "price") end up with the full beneficial ownership of the stock as well. It is true that the transaction makes no economic sense except as a gift and, if concluded between strangers, can be explained only by the hoped-for tax benefits. But a gift of stock to one's son with a retained right to the dividends for a time (or up to a stated amount) plainly has "substance," and a transaction does not have any less "substance" (nor is it, we think, any less a gift) simply because it is motivated by tax con-

siderations rather than by personal affection. What is a "sham" about the transaction, if anything, is not the transaction itself (real enough in its consequences), but simply the "sale" label the parties so assiduously tried to attach to it.[20]

The question this case presents, then, is not whether the transaction has "substance," but whether the "substance" of the transaction is that of a "sale" or only that of a transfer of property with a retained right to income. It is that question of the proper legal characterization of the transaction for tax purposes, turning ultimately upon the meaning and purposes of the capital-gains provisions of the Code, to which we now turn.

III

A TRANSFER OF STOCK IN WHICH THE TRANSFEROR RECEIVES NOTHING BUT A RIGHT TO THE DIVIDENDS UP TO A STATED AMOUNT AND A RIGHT TO RECOVER THE STOCK IF THE AMOUNT IS NOT RECEIVED BY A PRESCRIBED DATE IS MERELY A TRANSFER OF PROPERTY WITH A RETAINED INCOME INTEREST AND NOT A SALE.

The respondents contend, and the courts below held, that the transaction in this case was a "sale" within the meaning of the capital-gains provisions. The government contends that it was merely a transfer of property with a retained right to income plus, in this instance, a further retained right to recover the prop-

[20] Cf. *Knetsch* v. *United States*, 364 U.S. 361, where the taxpayer was out of pocket 90,000 very real dollars, but the *characterization* of those dollars as "interest * * * on indebtedness" was illusory, and "*As a payment of interest*, the transaction was a sham" (p. 365, emphasis added).

erty itself, or a share of its proceeds, if the income remittances should fall behind a prescribed schedule.[21]

Inasmuch as the instruments were prepared by parties who wished to have the transaction treated as a sale for tax purposes, it is not surprising that they provide an elaborate facade of documentation using the words "sell," "Purchase Agreement," and the like throughout. It is wholly clear, however, that documentary terminology is not controlling, and that calling a transaction a "sale" in formal documents does not make it a sale for tax purposes. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252. "It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." *Commissioner* v. *Duberstein*, 363 U.S. 278, 286.

If, then, formal terminology is not controlling, some more substantial basis for characterization must be found. By comparing those transactions which are clearly retained-income transfers with those which are clearly sales, we will show that the essential difference between them is the extent to which payment is assured independently of the future income produced by the property or of future changes in its value, from which it follows that this transaction, in

[21] Since the Institute had the right (though no obligation) to complete the payments out of its own funds, the transaction can be seen as also giving rise to an "option" in the Institute to buy the stock whenever the amount to be paid should be reduced sufficiently to make it advantageous for it to do so. The option was never exercised, however, and there is thus no question presented here as to what the effects of an exercise of the option would be.

which payment remained entirely dependent upon the future income from and value of the property, is not a sale. We will then show that that result is also required by the basic purpose of the capital-gains provisions to accord special treatment only to amounts which represent a realization upon the values accrued up to the time of the transfer, not those which represent a sharing in the gains or profits accruing from the asset after the transfer.

A. THE DIFFERENCE BETWEEN A TRANSFER OF PROPERTY WITH A RETAINED INCOME INTEREST AND A SALE OF THE PROPERTY SECURED BY THE PROPERTY ITSELF LIES IN THE DEGREE TO WHICH PAYMENT IS ASSURED INDEPENDENTLY OF THE FUTURE INCOME PRODUCED BY THE PROPERTY AND OF FUTURE CHANGES IN ITS VALUE

To show the essential difference between retained-income transfers and sales, we shall (1) establish that a transfer of stock on the transferee's promise merely to collect and remit the dividends for a time or up to a stated amount (*i.e.*, without, as here, any right of recourse against the stock itself) is plainly a retained-income transfer in which the dividends would be taxable to the transferor rather than the transferee; (2) establish that a transfer of stock on the transferee's payment of a substantial amount in cash and his promise to remit the dividends up to a stated amount, with the transferor having a right of recourse against the stock itself if he has not received payment by a day certain, is a "sale" in which the dividends remitted would be taxable to the transferee and not the transferor; and (3) then show that the only difference of substance between those two transactions is the reasonable assurance of ultimate payment, independent of the future dividend yield and

of at least substantial variations in the value of the stock, that the "down payment" in the second transaction affords. From that it will follow (4) that the presence in this case of the right to recover the property itself, or a share of its proceeds, if the dividends remitted do not reach a stated amount by a certain date—the only thing that differentiates it from the first case—does not make the transaction a sale, since that right by itself (*i.e.*, with no down payment) fails to provide any reasonable assurance of payment of the stated amount.

1. If *A*, owning rental property, conveyed a remainder interest to *B* and retained a life estate, no one would doubt that the rentals received by *A* during his life would be his income and would not be payments of a "purchase price" received by him from a "sale" of the property. To be sure, real property law would treat *A* as having an estate in land, but the result for tax purposes would be the same if *A* had purported to convey the land in fee simple to *B* on *B*'s promise (*i.e.*, a mere "contract" right) to collect and remit all the net rentals received during *A*'s lifetime.[22] That such differences are immaterial for tax purposes is, indeed, the most fundamental meaning of the doctrine that tax consequences turn upon the economic substance of transactions and not their legal form.[23]

[22] To eliminate any difficulties that might be introduced by *B*'s performance of services (see Point IV), it may be supposed that the property is to continue to be managed by the same real estate firm that managed it before the transfer, making *B*'s role purely passive.

[23] *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–267; *Burnet* v. *Harmel*, 287 U.S. 103, 110–111; cf. *Griffiths* v. *Helvering*, 308 U.S. 355; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331.

Nor, of course, would the results differ if *A* had reserved the right to the rentals for a fixed term of years rather than for a period measured by his life.

Similar transactions in intangible personal property rather than real estate are no different in principle, and if *A* transferred corporate stock to *B* subject to *B*'s promise to collect and remit the dividends for a stated term of years there would be no reason to characterize the transaction differently. Of course, many of such transactions would employ the mechanism of a trust, particularly if the amounts involved were large, and there the Code has provided explicit directions for taxation, at least in recent years. But if *A* felt he could rely on *B* (who might be, say, *A*'s son), the trust device might or might not commend itself to him for any of a number of reasons, and the tax results would be substantially the same. Nor, finally, would it make any difference if *B*'s promise were to pay over the dividends, not for a fixed term of years, but until the aggregate amount remitted reached a stated amount.

The inappropriateness of treating the yield from *A*'s retained income interest in such a transaction—*i.e.*, the annual dividends collected by *B* and paid over to him—as payments of a "purchase price" taxable to *A* only as capital gains is obvious enough. But even more incongruous would be the necessary corollary to that treatment—namely, taxing *B* on the full amount of the dividends collected by him notwithstanding his obligation to remit them to *A*. The duration or extent of the income reservation—*i.e.*, whether for 5 years, 20 years, or 50 years or until *A* has re-

ceived $100, $1,000, or $1,000,000—is solely a matter of *A*'s choice, depending simply upon how large an interest he wants to keep and how soon he wants the gift to *B* to become possessory. The total amount of the dividends collected by *B* and paid over to *A* is therefore wholly unrelated to the value of the stock, either at the time of the transfer or at the time *B*'s "remainder" becomes possessory. The ultimate receipt of the stock itself is, in turn, the only economic benefit that will ever accrue to *B* from the transaction. To tax him on the dividends, therefore, would be to tax him on amounts having no relation to any benefits realized by him. Whether or not the meaning of "income" as used in the Sixteenth Amendment requires it, the policy of the income-tax laws is to tax only values or benefits actually accruing to a taxpayer. Taxing *B* on 40 years' dividends because he will have the full beneficial ownership of the underlying stock at the end of that time could hardly be reconciled with that policy.

Without an elaborate facade of documentation and of "sale" terminology, not many taxpayers have had the hardihood to claim that a transfer of income-producing property in which the transferee undertakes merely to collect and remit the income for a time should be deemed a sale. When the argument was made in a few early cases, it was unhesitatingly rejected,[24] and since then there has been virtually no

[24] In *Bettendorf* v. *Commissioner*, 49 F. 2d 173 (C.A. 8), the owner of securities executed an instrument reciting that she "sold, transferred and delivered" the securities to the taxpayer, and the taxpayer "as a part consideration for such sale and transfer" agreed to collect the earnings and dividends and pay

further litigation of the matter in the lower courts—except of course in transactions, such as that involved here, in which the basic nature of the transaction is obscured by further complicating features. But while there is thus a sparsity of cases directly involving the simple form of retained-income transactions described above, any possible doubts about their treatment have been authoritatively resolved by this Court's decisions on analogous questions in the natural resources field.

While an outright sale of mineral interests qualifies for capital gains treatment, a purported sale of the mineral interests in exchange for a royalty from the

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them over to the seller during her life and then, her husband surviving, one half of the earnings and dividends to the "seller's" husband during his life. Thereafter there was to be no further obligation upon the taxpayer. The Commissioner, taking the "sale" at face value, asserted that dividends received were income of the taxpayer. The court rejected the Commissioner's position, and held that the income collected and remitted was taxable to the "seller" of the securities, not to the one who held legal title. "He paid nothing therefor, but agreed to the reservations attached to the gift." 49 F. 2d at 176. Accord: *Central Life Assur. Soc. Mut.* v. *Commissioner*, 51 F. 2d 939 (C.A. 8).

In *Fay* v. *Commissioner*, 34 B.T.A. 662, the taxpayer transferred securities to an institution which agreed to hold the securities, collect the income and transmit it to the taxpayer during his life, and then to his wife for her life. Thereafter the securities were to be devoted to the purposes of the institution. The taxpayer did not report income received from the institution, asserting that he had sold or exchanged his securities for an annuity, and had not yet recovered his cost. The Board of Tax Appeals rejected the taxpayer's claim, and upheld the Commissioner's asserted deficiency with respect to the remitted income. It remarked in language equally applicable to this case, "The grantor owned the securities transferred, and, as an incident of the ownership of those securities, was entitled

minerals produced is treated only as a transfer with a retained economic interest and the royalty payments are fully taxable as ordinary income (*Burnet* v. *Harmel*, 287 U.S. 103) and eligible for the depletion allowance (*Palmer* v. *Bender*, 287 U.S. 551). Most closely analogous is a "sale" of the minerals for a nominally fixed price, but with the "price" being payable only out of production (*e.g.*, a "sale" of all the minerals in place for $1 million payable out of ¼ of the first production). Because such an "oil production payment" is payable only if and when oil is produced, the seller

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to all the earnings or dividends therefrom. A transfer of the securities was made to the Institute for certain designated purposes, but the grantor never at any time parted with the right to receive the income." 34 B.T.A. at 667. Cf. also *Morton* v. *Commissioner*, 23 B.T.A. 930, affirmed *per curiam*, 61 F. 2d 1036 (C.A. 2).

An analogous question is posed by the estate-tax provision (§ 2036) including in the gross estate any property of which the decedent has made a transfer, except in "a bona fide sale for an adequate and full consideration in money's worth," in which he has retained a right to the income for a period that does not end before his death. For that purpose, the Tax Court had no difficulty in concluding that a transfer of stock "subject to your giving me the first dividends on these up to $15,000" was a reservation of income and not a sale." *Estate of Fry* v. *Commissioner*, 9 T.C. 503. In estate tax cases involving intra-family transfers, indeed, some courts have gone much further, finding that there was in effect a reservation of income when the amounts to be paid by the children (the transferees) coincided with the expected income yield from the securities even though the children were nominally personally liable for the payments, but those decisions would appear to be based on considerations peculiar to estate tax policies and to the problem of the recognition to be given to intra-family "obligations." See, *e.g.*, *Updike* v. *Commissioner*, 88 F. 2d 807 (C.A. 8); *Greene* v. *United States*, 237 F. 2d 848 (C.A. 7); but cf. *Lincoln* v. *United States*, 65 Ct. Cls. 198.

is held to have retained an economic interest in the future production and hence not to have made a "sale" of the property, notwithstanding that the transaction is effective to convey title as a matter of state law and that, once the pay-out is completed, full ownership of the minerals will vest in the "purchaser." *Thomas* v. *Perkins*, 301 U.S. 655.[25]

In their analysis those cases are also dispositive of the only discernible basis for the decisions below—to wit, that there was a completed transfer of the stock as a matter of property law, leaving the stockholders with no "property" interest in the stock but only "contract" rights to be paid certain amounts. The government made almost exactly the same argument in *Palmer* v. *Bender*, 287 U.S. 551, contending that an owner of a mineral lease who had transferred the lease to an oil company in exchange partly for an oil production payment and a royalty was not entitled to depletion because under State law the transfer was an absolute "assignment" and he no longer had a "property" interest in the minerals. Noting that it had been "elaborately argued * * * whether under Louisiana law the two instruments are assignments or subleases," this Court held that the "formal attributes of

[25] See also *Palmer* v. *Bender*, 287 U.S. 551. Compare *Anderson* v. *Helvering*, 310 U.S. 404, where there was a down payment of almost one-third of the price and the balance, with 6% interest, was payable either out of production or from a sale of the properties. Because the payment was not dependent solely upon production and the property itself furnished security (enhanced, it should be noted, by the substantial down payment), the Court, distinguishing *Perkins* on that ground, held the transaction to be a sale.

those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant" (pp. 555–556). The depletion allowance, the Court said, "does not depend upon * * * retention of ownership or any other particular form of legal interest in the mineral content of the land," but is available whenever "the taxpayer has acquired, by investment, any interest in the oil in place, and secures, *by any form of legal relationship*, income derived from the extraction of the oil" (p. 557, emphasis added). See also *Thomas* v. *Perkins*, 301 U.S. 655; *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308. While most of those cases involved the right to depletion, the treatment of the royalties as ordinary income is prerequisite to the allowance of depletion upon them. One can have ordinary income that is in some way dependent upon oil production without being entitled to depletion,[20] but one cannot be entitled to depletion without having ordinary income. And, if anything, "property" concepts are far more germane to depletion than they are to the characterization of receipts as capital gain or ordinary income.

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[20] The notion that, to have a depletable interest in the exhaustion of the mineral deposit, one must have a direct and immediate interest in the mineral itself (virtually in kind, as it were) goes far to explain the initial difficulty the Court had in allowing depletion based on a "net profits" interest—*i.e.*, a right to a share of the net profits from an oil production enterprise rather than to an amount measured directly by the gross proceeds from the sale of the oil. The Court first denied depletion on such an interest (*Helvering* v. *O'Donnell*, 303 U.S. 370;

If a transfer of a mineral interest with a retained right to a share of the proceeds of production up to a stated dollar amount is not a "sale," *a fortiori* a transfer of corporate stock with a retained right to the dividends (or a share of them) up to a stated dollar amount is not a "sale." The cases are identical in that the transferee's obligation is limited to remitting whatever income or production is realized and in that the transferor's interest in the property is to terminate entirely once the stated amount has been received. They differ only in that, in the oil-payment case, the transferee himself contributes materially (by drilling the well) to the production of the income that is remitted to the transferor, while, in the retained-dividends case, the transferee merely collects and remits dividend income to the production of which he has contributed nothing. The substantial contribution to the production of the income which is made by the transferee of the mineral interests gives at least some color to the contention that the income is earned by (and properly taxable to) him and is then paid

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Helvering v. *Elbe Oil Land Co.*, 303 U.S. 372) but later all but overruled those cases (*Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; see also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308). Whether the earlier cases retain any vitality at all, the distinction there drawn between a gross-proceeds interest and a net-profits interest can be germane, if at all, only to the depletion question. While there might be some reason for limiting the special privilege of a percentage-depletion deduction to those with a "direct" economic interest in the oil itself, a right to a share of the future net profits from the enterprise is, if anything, much more obviously an *income* interest than is a right to a gross share of production.

over to the transferor as a payment of the "purchase price" for the interests;[27] a similar claim as to the transferee of stock who serves only as a conduit to collect and remit the dividends paid on the stock is not even colorable.

The treatment of the simple transactions we have thus far described is not, we believe, subject to serious doubt, and we do not anticipate that it will be challenged by respondents. Their claim to a different treatment here turns rather upon the presence of the further condition that, if the stated amount has not been received by a day certain, the transferors are entitled to cause the stock to be sold and to have the proceeds paid to them to make up the deficiency. Whether the presence of that additional condition is sufficient to convert the transaction into a sale is, as we have noted, the ultimate question to be answered.

2. To be contrasted with the transactions just described which clearly involve only a retention of a right to the income from the property are the transactions which equally clearly are sales. Certainly the model "sale" is a transfer of property in which the transferor completely severs his relationship to the property and receives full payment in cash. Yet credit transactions make up a large part of the universe of sales, and a transfer of property in exchange for a promise to pay a fixed amount, made by a solvent individual or entity from whom ultimate payment is reasonably assured, is equally a "sale." A

[27] For the possible significance of the transferee's contribution to the production of the income to be remitted, see Point IV, *infra*.

still further step is the elimination of the transferee's personal liability to pay the purchase price. Even though the transferee be not liable, the transaction would still qualify as a sale if the payment of the price were adequately secured by, say, the pledging of other assets or the personal liability of a solvent guarantor. The final instance is the case in which the transferee is not personally liable and no independent sources of payment are pledged but a substantial down payment is made and the property transferred is itself pledged to secure the payment of the balance of the purchase price. If the down payment is large enough so that the balance of the purchase price is substantially less than the value of the stock, the pledge of the stock without more provides reasonable assurance of payment and plainly qualifies the transaction as a sale.

Subject to the questions of degree implicit in those statements, we acknowledge that all of those transactions would properly be treated as "sales" and that the payments to the transferor would be taxable only as capital gains (except, of course, to the extent that they constituted interest). And if a transaction were otherwise a sale, it would obviously not make it any the less a sale if, to provide additional assurance of payment, it were further provided that any income from the property would be remitted to the transferor to be applied against the balance due until he had been fully paid. It follows, then, that if *A* transfers stock to *B* on *B*'s payment of a "substantial" amount in cash and his promise to remit the dividends until a stated further amount has been paid, and if *A*

in addition is entitled to cause the stock to be sold and to receive the balance due out of the proceeds if he has not been paid by a day certain, the transaction would qualify as a "sale".[28] Once again, however, that fails to dispose of this case since, although a fixed amount was stated as the "purchase price" and the assets transferred were pledged for its payment, the Institute was not personally liable, no down payment was made, and no other assets were pledged or guaranty given.

3. We may begin the analysis of the differences between those "clear" cases of retained-income transfers, on the one hand, and sales, on the other, by first noting those aspects which are plainly *not* the distinguishing features. The parties' labeling of the transaction as one or the other[29] is, as we already know, wholly irrelevant—however elaborate or expensively printed be the document in which the labels are used. The difference is not whether the income from the property is required to be or is in fact paid over to the transferor, since that may be equally true of sales. Nor can the difference be, as the Tax Court and the court of appeals seemed to think, whether there was a transfer of title or ultimately of the full beneficial ownership, for that is equally true, as we have seen, of transfers with a retained income interest. The fact that under certain circumstances the

[28] See Rev. Rul. 56-153, 1956-1 Cum. Bull. 166, and cases there cited.

[29] Or, as it is sometimes put, whether the parties "intended" the transaction—otherwise the same in terms of the substantive rights and duties created—to "be" a sale or not.

transferor may be entitled to recover the property transferred (at least in part) surely cannot, in and of itself, be what makes a transaction a sale. If in other respects the transferor's rights have the characteristics of a retained income interest, a further possibility of also recovering the property itself would prove, if anything, only that he has parted with less, not more, and thus make the transaction even less a sale.

What, then, is the difference between sales and transfers with income reserved? It is, we submit, simply the differing effects the transactions have upon the extent to which the transferor's receipts are *dependent* upon the future income yield from the property or upon future changes in its value. In short, the difference is risk-shifting. It requires no more than a brief analysis of the two classes of transactions in those terms to see the reality of that difference.

If *A* transfers stock to *B* subject to *B*'s undertaking to collect and remit the dividends for a stated time or up to a stated amount, what *A* ultimately receives—if, indeed, anything—is entirely dependent upon what income is produced by the stock in the future. He thus bears the entire risk whether the asset transferred will or will not prove to be productive in the future. That is evident from the simple fact that *B* has contributed nothing which could in any way insulate *A* from those risks, and the risks borne by *A* after the transaction are thus exactly the same, both in quality and in degree, as the risks borne by him before the transaction. By such a transfer, *A* merely *limits* his previously all-inclusive rights,

and the relationship of the limited rights he retains to the underlying asset remains unchanged. There is no "conversion" of his interest into something else or something different and hence there is no "sale".

All of the model "sale" transactions, in contrast, result in a significant change in the transferor's economic relationship to the assets and in the risks borne by him. In the purest example of a sale—a transfer for an immediate cash payment—the change is, of course, the most complete: *A* terminates his relationship to the asset and pockets its present cash value; *B* bears all the risks, and is entitled to all the benefits, of the future income productivity of the asset (or changes in its value). Only slightly less complete is the change when *A* receives the personal obligation of a solvent entity to pay a fixed amount. While the dividends from the stock may in fact be remitted to *A* in payment of the obligation, *A*'s right to payment is not dependent upon there being dividends; even if there were no dividends, *A* would still be entitled to collect the same amount from *B* or from any other assets of *B*'s. To be sure, *A* does have a risk that *B* will become insolvent, but, if *B* had substantial other assets or income-producing capacity at the time of the transfer, that is a very different risk from that previously borne by *A* as the owner of the stock. The change is least complete, but still significant, when there is a substantial down payment but *B* is not personally liable and the payment of the balance of the purchase price is secured only by a pledge of the stock itself. Since *A* has a prior right to be paid the balance of the purchase price before *B* re-

covers his investment—*i.e.*, the down payment— it is *B*'s investment that bears the primary exposure to the risks of future gains or losses. Bearing the primary risks, he is entitled to the correlative benefits and, if the down payment is large enough to cause a significant shifting of the risks, he has the necessary economic bargaining power to insist upon a purchase price approximating that which would be arrived at in a cash sale. With an immediate payment of a substantial part of the purchase price and a pledge of the stock to secure payment of the balance, therefore, *A* has recourse for the payment of the balance of the price against assets (the stock itself) worth substantially more than the amount of his claim. While the transaction would also normally provide for the remittance of the interim dividends, the effect of the "cushion" afforded by the down payment is that *A* is no longer *dependent* upon the dividends for payment. Even if there should be no dividends, *A* would be entitled to collect the same amount by foreclosing on the pledged stock, an amount which there is a reasonable assurance the stock, having initially been worth substantially more than the balance due, will yield.

The relevance to characterization as a "sale" of the shifting of the risk of future losses and the benefit of future gains that occurs in the latter class of transactions is plain. By such a transaction, *A* gives up his "equity" interest in the asset—bearing the risks and benefitting from the gains—and becomes a mere "creditor" with an adequately secured claim in a fixed amount. Even though his only recourse be

against the very asset he transferred (*i.e.*, where there is a substantial down payment but no personal liability), he no longer has a risk-bearing, income-sharing interest "in" the asset but only a creditor's claim "against" it. That basic change in the nature of his relationship to the asset—not present, as we have seen, in retained-income transfers—is sufficient to treat him as having converted his former interest into something else. And it is just such a "conversion" of one's interest in an asset that is the essence of a "sale" and that makes it an appropriate occasion to require the seller to account for the gains and losses accrued from his investment up to that time.

4. If we are correct as to why the clear cases of sales are sales and why the clear cases of transfers with income reserved are not, there can be no difficulty in properly classifying the transaction in this case. While respondents had a right not only to a remittance of the dividends up to a stated amount but also (unlike the clear cases of retained-income transfers) a right to recover the stock, or a share of its proceeds, if the stated amount was not received by a prescribed time, the addition of the latter right is relevant only to the extent that it does in fact operate to afford a reasonable assurance of ultimate payment regardless of the future dividend yield or of future changes in the value of the stock. That is true when there is a down payment which is substantial in relation to the "price" to be paid, since the very fact of the down payment, and the risk-shifting that results from it, establishes that the parties have bargained on the economic terms normal to the market

place and, hence, that the "price" represents the present value of the stock. A right of recourse against the stock, worth the full price, for the payment of only a fraction of the price thus affords reasonable assurance of payment. Here, however, there was no down payment,[30] and since there is no claim that the transaction was donatively motivated we need not even reach the question whether, if the "price" were substantially *lower* than the present value of the stock even though there was no down payment—with there being, in effect, a gift of the substantial equity interest which a "buyer" normally acquires with a down payment—the transaction would qualify as a "sale."

The parties to the transaction in this case, as respondents have consistently asserted, dealt at arm's length with each other, each seeking to serve his own ends. In such a transaction—*i.e.*, a transaction between strangers in which the transferee furnishes nothing—either the amount of the dividends to be remitted to the transferor must be substantially greater that the present value of the stock or the transferor must be a fool, an explanation not to be presumed. Thus the courts below were, if anything, guilty of understatement in their acknowledgement that the

[30] There was, to be sure, an immediate distribution to respondents of $5,000 out of the corporate assets, but that came out of the very property transferred, not from the transferee, and thus in no way shifted the risks. The same thing would be true, of course, of a "down payment" made by a transferee which he is entitled to recover from the assets *prior* to full payment of the tranferor's claim. A down payment serves to shift the risk only when the "equity" thereby acquired by the transferee is *subordinated* to the transferor's claim.

amounts to be remitted may have been "somewhat higher" (R. 62) or were "probably greater" (R. 295) than the amount respondents could have realized from their stock in any other kind of transaction. And if the amounts to be remitted are greater than the present value of the stock, then it is obvious that the right of recourse against the stock in no way removes the transferor's continued dependence upon future income production or future changes in the value of the stock for payment of the stated amounts. Indeed, all that the addition of that right means is that the transferor has retained not only the benefit of future dividends but also the benefit of any future appreciation in the value of the stock as well.

In such a transaction, in short, the transferor retains not only the full risk of future losses but also at least a share of the benefit of future gains (either from dividends or from capital appreciation). He remains fully subject to exactly the same risks he bore before and has simply imposed an upper limit (presumably in the hopes of thereby realizing some tax advantage) on his right to the future benefits. There has been no conversion of his interest, through risk-shifting, from an "equity" interest in the stock to a "creditor's" claim against it, and what he has left after the transaction is but a lesser part of what he had before. Such a transaction is not a "sale." It is but a gift of a contingent future interest[21] in the

[21] We are speaking, of course, of a case in which 100% of the dividends are to be remitted. Here the Institute was not only given the possibility of ultimate beneficial ownership but also an interim right to 10% of the dividends.

stock—albeit one motivated solely by a hoped-for tax benefit rather than charitable impulses—and a retention of everything else. The dividends remitted to the transferor pursuant to that retained right, it follows, are taxable to the transferor, not the transferee, and wholly fail to qualify for capital gains treatment.[22]

5. It hardly needs adding that whether any given down payment or pledge of other assets or of personal liability is sufficient to qualify a particular transaction as a sale is, of course, a question of degree, requiring a judgment based upon all the circumstances bearing on the extent to which there has been a significant shift of the risks. The judgment would have to take into account, for example, not only the absolute amount of the down payment or its relationship to the price but also such factors as the speculative or stable nature of the asset: the down payment required to make a transfer of stock in a corporation owning only government bonds a sale might be quite different from that required if the corporation is a new one just embarking on the development of a new product. None of those questions are faced in this case, however, for the simple fact is that the Institute furnished nothing at all and there was thus *no* risk-shifting. For that reason, the difference here is not one of degree but is, in fact, one of kind. The question is simply whether there can be a "sale" where

[22] The effect of a later exercise by the transferor of his right, upon certain events, to have the stock sold and to receive the proceeds is, of course, an entirely different question. Although there was such a final disposition of the property in this case in 1958, that year is not before the Court.

there is no risk-shifting at all and the transferor remains *entirely* dependent for payment upon the future income yield from, or future changes in the value of, the very property transferred. The answer to that question, we submit, cannot be in doubt.

B. THE PURPOSE OF THE CAPITAL-GAINS PROVISIONS TO AFFORD SPECIAL TREATMENT ONLY TO AMOUNTS WHICH REPRESENT A REALIZATION UPON VALUES ACCRUED UP TO THE TIME OF THE TRANSFER, AND NOT TO AMOUNTS WHICH REPRESENT A SHARING IN THE GAINS OR PROFITS ACCRUING FROM THE PROPERTY AFTER THE TRANSFER, REQUIRES THAT THE TRANSACTION IN THIS CASE NOT BE TREATED AS A SALE

The capital-gains provisions "must not be so broadly applied as to defeat rather than further the purpose of Congress," and this Court "has always construed narrowly" the definitional provisions in order to prevent a frustration of that purpose. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51–52; see also, *e.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Burnet* v. *Harmel*, 287 U.S. 103. The difficulty comes, of course, in knowing what that purpose is, for in many circumstances the purpose may be obscure. But however much doubt there may be about the policies of the capital-gains provisions in other respects, about one thing there can, we submit, be no doubt: that Congress never intended to accord capital-gains treatment to anything more than a realization upon the *present* value of an asset at the time of its transfer, and that any application of the provisions that permits the fruits of a continued sharing in the *future* gains and profits produced by the asset to be taxed

only as capital gains is basically offensive to the purposes of those provisions.

Special tax treatment was first accorded to capital gains—defined in terms substantially identical to the present law [33]—by the Revenue Act of 1921. The reason given for the special treatment was that (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11):

> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum * * * in the year in which the profit is realized.

The only thing that was intended to be given preferential treatment, then, was the realization, by a sale, of "gains and profits earned over a series of years" in the past and thus reflected in the present value of the asset *at the time of the sale.* It was only that value that was in any danger of being realized "as a lump sum" and it was therefore only the realization on that value that was meant to be given special treatment. To allow the yield from a retained right to share in the future gains and profits produced by the asset to be taxed only as capital gain would therefore be directly opposed to the explicitly stated purpose of Congress.

The same limitation is implicit in the requirement of the statute that, for capital-gains treatment, the asset must have been held for a stated period (now,

[33] "The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921." § 206(a)(1), 42 Stat. 232.

six months) prior to its "sale," a requirement that makes sense only if the gain realized and accorded capital-gains treatment represents values that accrued during that period—*i.e.*, up to, but not after, the date of the sale. The conclusion is equally dictated by this Court's repeated recognition that the purpose of the capital-gains provisions was to afford relief from the application of the steeply progressive ordinary rates to the realization in a single year of values that may have accrued over many years in the past. *E.g., Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265; *Burnet* v. *Harmel*, 287 U.S. 103. That purpose obviously does not warrant extending capital-gains treatment to annual receipts derived from a continuing risk-bearing participation in the future income from the asset.

In this case, as we have shown, the stockholders retained not only the full risk of future losses but also a right to a share of the benefits from future gains, either from future income production or from future capital appreciation. They chose to continue to bear those risks in the hopes that their receipts would ultimately be greater than the amount they could have realized by "cashing in" on the present value of the stock. To allow them both to have the fruits of their continued risk-bearing and yet to receive the preferential treatment accorded to capital gains—in short, to hold that this transaction was a "sale"—would thus be directly contrary to the purpose of the statute.

IV

TRANSACTIONS IN WHICH THE TRANSFEREE CONTRIBUTES TO THE PRODUCTION OF THE INCOME TO BE REMITTED ARE DISTINGUISHABLE AND THE PROBLEMS THEY PRESENT NEED NOT NOW BE RESOLVED

In this case, and in the other transactions we have analyzed, the transferee was to perform a purely passive role, merely collecting and remitting the income produced by the asset without in any way contributing to its production. In transactions in which the transferee, either by performing services or making an additional investment, is to contribute to the production of the income to be remitted, there is an additional element which may, at least in some circumstances, as will show, justify a different result.

Because the contribution of the transferee to the production of the income may at least sometimes justify a different result, the presence of such a contribution by the transferee provides a sufficient distinction, for present purposes, between this case and the lower court decisions which, in conflict with the Second Circuit, accord capital gains treatment to patent royalties. Lest respondents seek to draw comfort from those cases, however, we will go on to show that those cases were in any event wrongly decided and are, in fact, directly contrary to the "economic interest" principle established by this Court's decisions in the oil-royalty cases.

1. Suppose that *A* transfers farm land to *B* on *B*'s agreement to farm the land and remit all of the income to *A* until *A* has received a stated amount,

whereupon *A*'s interest is to terminate, and that *A* also has the right to "foreclose" on the property for the balance due if the remittances fall behind a prescribed schedule. One way of analyzing that transaction is to see *A* as simply buying *B*'s services for the period of the "pay-out" in exchange for the transfer of the full beneficial ownership of the land at the end of that period: *A* would be taxed on all of the remitted income subject to a deduction for the "wages" paid (*i.e.*, the land[34]); *B* would receive the land itself as "compensation" earned by his services, presumably taxable, if he is on the cash basis, in the year when the pay-out is completed.[35] Another way to see the transaction (we do not say it would be a practical solution) is as a retention of a term interest and a "sale" of the "remainder." Assume that in a normal crop-sharing arrangement, involving no disposition of the land, the income would have been divided 60% to *A* and 40% to *B*. If so, the income during the pay-out period could be seen as attributable 60% to *A*'s investment in the land and 40% to *B*'s services (*i.e.*, in the normal proportions) and be taxed accordingly, with *B*'s 40% of the income then being remitted to *A* in payment for the "remainder" interest in the land—*i.e.*,

[34] There is an unresolved question whether, if appreciated property is used to pay for services, the deduction should be limited to the basis of the property or whether there is a "realization" of the appreciated value, taxable as capital gain but entitling the transferor to an ordinary deduction for the full value of the property.

[35] The receipt might qualify for income-averaging under § 1301, either before or after its amendment by the Revenue Act of 1964, § 232(a), 78 Stat. 19.

for its full beneficial ownership after the pay-out is completed.

Yet it would also be plausible to treat the transaction as a whole as a "sale," particularly if *B* had committed himself to continue to farm the land until the pay-out is completed. By furnishing valuable services but subordinating his right to any part of the income until *A* has been fully paid, *B* has greatly increased the assurance that *A* will receive the stated amount and has shifted to himself the primary risks and benefits accruing from the possibility that the income yield will be more or less than anticipated. He has, in short, "underwritten" by the investment of his services the receipt of the stated amount by *A*. Particularly in view of the relatively stable nature of the enterprise—the substantial certainty that with *B*'s contributed services, the farm *will* eventually produce enough income to pay off *A*—that shifting of the risk may be sufficient to warrant treating the whole transaction as a sale, taxing all of the income to *B* and according capital gains treatment to *A*. The very fact of the shift of the primary risk, it should be noted, gives *B* an economic bargaining position, and, since he must invest valuable services yet defer any realization until *A* has been paid, he would presumably be unwilling to agree to a "price" greater than he thought the property worth.[36]

[36] The supposed transaction, it will be seen, is analogous to that involved in *Thomas* v. *Perkins* (301 U.S. 655) mentioned earlier (pp. 44–49, supra), where *A* transferred mineral interests to *B* on *B*'s undertaking to develop the property (*i.e.*, drill a well) and to pay over to *A* a fraction of any oil pro-

The point is not that a contribution by the transferee to the production of the income (even a major one) will *always* make the transaction a sale,[37] but only that it is itself an important factor in appraising the extent to which there has in fact been a sufficient shifting of the risks to qualify the transaction as a sale.

To be distinguished from the kind of risk-*shifting* that occurs in the first example is the mere risk-*sharing* that occurs when *A* furnishes an asset which *B* is to make productive subject to an agreement to share the income produced over the entire life of the asset. Suppose, for example, that *A* owns only a 20-year leasehold in farm land which he conveys to *B* on *B*'s agreement to farm the land and to remit 60% of the income produced over the entire

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duced until *A* had received a stated amount, whereupon *A*'s interest was to terminate. There, the Court held that no part of the transaction was a sale and treated *A*'s entire receipts as simply the proceeds of a retained income interest, despite the major investment made by *B* in producing the income paid over to *A*. That case can be distinguished, however, on the ground that, because it remained wholly speculative and contingent whether *any* income would be produced, *B*'s investment in drilling the well in no way insulated *A* from the risks of production or non-production. Instead of "cashing in" on the value of the mineral interests by an outright sale, *A* kept an interest in whatever oil might be produced and thus "gambled" on oil being discovered, and it can hardly be supposed that the amount to be paid him when the gamble paid off would bear any relationship to the realizable value of the property at the time of the transfer.

[37] For an intermediate case posing a much more difficult problem of characterization, see *Vermont Transit Co.* v. *Commissioner*, 19 T.C. 1040, affirmed, 218 F. 2d 468 (C.A. 2); but cf. *Crabtree* v. *Commissioner*, 22 T.C. 61, affirmed *per curiam*, 221 F. 2d 807 (C.A. 2).

20-year term. *B*, to be sure, does put an investment at risk in the enterprise, but it is not one that insulates *A* from the same degree of risk: *A* and *B* have merely shared the investment in, the risks of, and the income from, the venture in the same proportions. The transaction amounts simply to a joint undertaking in an income-producing activity—with each contributing a different factor of production, one the land and one the labor—and the income should obviously be taxed 60% to *A* and 40% to *B*. Nor, of course, should it make a difference whether *A*'s share is defined as a percentage of gross income, as a percentage of net income, or as a fixed amount per bushel of wheat sold. In either case, what he receives is entirely dependent upon what is produced and in no way reflects the value of his leasehold on the date of the transfer nor, hence, what he might have realized by "cashing in" on that value and being relieved of any further risks.

The case last supposed, it may be seen, is an exact parallel to *A*'s transfer of a patent to *B* on *B*'s agreement to pay *A* a "royalty" equal to a stated percentage either of the gross proceeds or of the net income from the manufacture and sale of the patented item over the life of the patent. Even though in property law terms there may have been a completed "transfer" of the patent—just as there may have been of the leasehold in the preceding case—the arrangement results simply in a joint undertaking in the exploitation of the invention: *A* furnishes the patent; *B*, the manufacturing and the selling; and *A* and *B* then

share the income in proportion to their respective contributions to its production and to the risks they each continue to bear. While the *value* of *A*'s royalty contract on the date of the transfer presumably reflects the then value of the patent, whether the exploitation of the patent will prove successful and, if so, to what extent is entirely speculative, and the amounts actually remitted to *A* when the venture does prove successful obviously bear no relationship to the realizable value of the patent at the time of the transfer. The receipts, in short, in no way represent a realization upon "gains and profits earned over a series of years [prior to the sale]" (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11)—they are rather profits accruing after the transfer from *A*'s continued risk-bearing participation in the fruits of the exploitation of the patent—and are thus plainly not the kind of gain that Congress meant to qualify for the special treatment accorded capital gains.

Yet among the courts of appeals, the Second Circuit stands virtually alone in analyzing patent-royalty cases in those economic terms, an analysis which, of course, unavoidably led it to the conclusion that there was no "sale" and that the proceeds of the patentee's continuing interest in the successful exploitation of the patent were taxable as ordinary income. *Bloch* v. *United States*, 200 F. 2d 63. Most of the other lower courts have asked only whether, in property law terms, there was a complete transfer of all the "property" interests in the patent, seeking to find the answer in the distinction between an "assignment"

and a "license" of a patent drawn by this Court years ago in *Waterman* v. *Mackenzie*, 138 U.S. 252, in order to determine which party was entitled to maintain a suit for an infringement of the patent. Finding that there was an "assignment" rather than a mere "license"—finding, that is, that *B* could sue for patent infringement—the courts have merely assumed without discussion that that answered the tax question and have accordingly taxed the royalties only as capital gains.[38] No doubt the failure of analysis is attributable largely to the fact that the cases were generally argued by parties, including the government, in the same property-law terms in which they were decided.[39] But while that may make the error understandable—and, because the real issue was never argued, weaken the authority of those cases—the error is, we think, no less plain. Indeed, the cases according capital gains treatment to patent royalties are not only wrong in principle but they are, we submit, squarely in conflict with this Court's decisions, discussed above at pp. 44–49, holding oil royalties to be taxable as ordinary income, for there is simply no meaningful distinction to be drawn between the royalties received by a transferor

[38] *E.g.*, *Commissioner* v. *Celanese Corp.*, 140 F. 2d 339 (C.A. D.C.); *Allen* v. *Werner*, 190 F. 2d 840 (C.A. 5); *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10); *Massey* v. *United States*, 226 F. 2d 724 (C.A. 7); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9); *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); *Kronner* v. *United States*, 110 F. Supp 730 (Ct. Cls.).

[39] If the royalty aspect was mentioned at all, it was referred to simply as one of the "factors"—together with, *e.g.*, retained powers of control—which indicated that the particular transfer was "really" a "license" rather than an "assignment."

of mineral interests and those received by a transferor of patent interests.

While the treatment of patent royalties has now been resolved by statute as to certain patent transfers,[40] the question remains viable as to some of the most common, among them transfers to controlled corporations, probably the class with the most important tax implications.[41] Essentially the same question is presented, moreover, by transfers of a franchise subject to a royalty, the litigation over which, although similarly becoming enmeshed in property concepts, has produced results considerably less uniform than the patent-royalty cases.[42] Another prevalent practice which presents substantially the same question is the transfer of land to a cemetery association in exchange for a percentage (often, 50% or more) of the proceeds of the association's resale of the land as burial lots, but there the litigation to date has

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[40] 1954 Code § 1235; 1939 Code § 117(q), added by the Act of June 29, 1956, 70 Stat. 404. See *United States* v. *Zacks*, 375 U.S. 59. The statute accords capital-gains treatment to the transfers to which it applies, but it generally applies only to transfers by the inventor and then only if the transfer is to an unrelated party.

[41] In 1958, however, the Internal Revenue Service, faced with a mounting tide of adverse decisions, was forced to cease litigating the question, at least for the time being. Rev. Rul. 58–353, 1958–2 Cum. Bull. 408.

[42] See *Dairy Queen of Oklahoma* v. *Commissioner*, 250 F. 2d 503 (C.A. 10) (both lump sum payment and royalties are capital gain); *Gowdey* v. *Commissioner*, 307 F. 2d 816 (C.A. 4) (only lump sum is capital gain); *Moberg* v. *Commissioner*, 305 F. 2d 800 (C.A. 5) (same); *Moberg* v. *Commissioner*, 310 F. 2d 782 (C.A. 9) (neither lump sum nor royalties capital gain).

centered on the exempt status of the association[43] rather than the tax treatment of the transferor.[44]

Despite the continuing importance of the question and what seems to us the clear error of the cases according capital-gains treatment to patent royalties, however, it is not a question that need be reached in this case. In such transactions, the transferee does make a major contribution to the production of the income to be remitted and that is, as we have shown, an important difference which, in some contexts at least, might justify a different result. Even in the patent-royalty cases, that factor at least gives some color to the claim that the income is "earned" by the transferee and ought to be taxed to him, and it may be doubted whether even a court which accorded capital-gains treatment to patent royalties would be willing to grant the same boon to one who transferred stock on the transferee's undertaking merely to collect and remit the dividends for, say, 17 years. To that extent at least the cases have been influenced by the transferee's contribution to the production of the income, and, since any such contribution is wholly

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[43] See *Commissioner* v. *Kensico Cemetery*, 96 F. 2d 594 (C.A. 2); *Forest Lawn Memorial Park* v. *Commissioner*, 45 B.T.A. 1091.

[44] But see *Sherwood Memorial Gardens, Inc.* v. *Commissioner*, 42 T.C. 211, where a somewhat more complicated transaction was treated consistently with our analysis here. For the extent to which the promoters' hopes of realizing the proceeds from burial-lot sales as capital gains may account for the high-pressure salesmanship practiced by the rapidly mushrooming "non-profit" cemetery associations, see Mitford, *The American Way of Death* (1963), particularly Chapter 9, "God's Little Million-Dollar Acre."

lacking in the case, the Court may fairly confine its decision to that circumstance and leave to another day the treatment of patent royalties and the like.

V

NO ISSUE HAS YET BEEN RAISED IN THIS CASE, OR CONSIDERED BY THE COURTS BELOW, AS TO THE EFFECT UPON RESPONDENTS OF THE SUBSE NT STEPS OF THE TRANSACTION (THE LIQUIDATION OF THE CORPORATION AND THE TRANSFER OF ITS ASSETS TO A NEW CORPORATION) IF THE INITIAL TRANSFER OF THEIR STOCK WAS NOT A "SALE," AND NO SUCH ISSUE IS NOW BEFORE THE COURT OR NEED BE DECIDED

We have shown that, if the transaction in this case had been limited to a transfer of the stock to the Institute on its promise to remit 90% of the dividends up to $1,300,000, with the respondents having the right to recover the stock (or a share of its proceeds) if less than $250,000 was received in any two-year period, the transaction would not qualify as a "sale" and respondents' annual receipts of the remitted dividends would thus not be taxable as the proceeds of a sale. That the purported sale of the stock was in fact followed by the Institute's liquidation of the corporation and "lease" of its assets to a new operating company can in no way affect that conclusion, and we do not believe respondents will contend otherwise. If the initial transaction was not a "sale," however, it is at least possible that the subsequent steps would have some independent consequences affecting the proper tax treatment of respondents' receipts. Those, however, are wholly different ques-

tions from the question decided by the courts below and the question brought here for review. They need not—indeed, ought not—be explored here for the first time, and if the Court agrees with us that the first step in the transaction was not a "sale" the proper course would be to remand the case to the Tax Court for a consideration of the effect, if any, of the subsequent steps. Indeed, as yet respondents have made no claim that the subsequent steps would affect the treatment of their receipts if there was no "sale" of their stock, so that any consideration of those questions now would be wholly premature. We shall, accordingly, merely indicate the nature of some of the possible questions that might be raised by the subsequent steps and in no way attempt to answer them.

1. There are in the tax law many issues as to the proper tax treatment of shareholders even when they do not purport to "sell" their stock to third parties (*e.g.*, whether their dividends are out of "earnings and profits.") It should therefore not be surprising that a holding that respondents' transfer of their stock to the Institute was not a "sale" would not automatically determine the proper treatment of all their subsequent receipts or the effect of the subsequent steps in the transaction.[45] The questions as to the

[45] For example, even in the simple case in which *A* transfers stock to *B* solely for *B*'s promise to remit the dividends for 20 years, a holding that the transaction is not a "sale" and that the dividends remain "taxable" to *A* would not in itself determine the proper tax treatment of the subsequent dividends, which would turn upon whether they were out of "earnings and profits" of the corporation. The further questions discussed here bear the same relationship to the "sale" question.

effect of the subsequent steps are, indeed, largely the same questions that would have been raised if respondents had not first purported to sell their stock to the Institute but had themselves liquidated the old corporation and transferred its assets to Fortuna on the same terms.

If respondents had themselves liquidated the old corporation and "leased" its assets to Fortuna for 80% of Fortuna's net profits (*i.e.*, the same transaction but omitting the transfer of the stock to the Institute[46]), there would have been presented a number of questions the primary thrust of which would be whether the profits remitted by Fortuna as "rentals" would escape the corporation income tax, but which would also affect the treatment of the individual stockholders. The first question would be whether the liquidation and transfer of the assets to a new corporation qualified as a tax-free "reorganization"—a question which might depend, for example, upon whether respondents' "lease" rights to 80% of Fortuna's net profits should be treated as a "stock" interest in Fortuna and whether the "voting" rights of respondents' attorneys (to whom all the voting stock was issued) could be attributed to respondents (see § 368). If there was a "reorganization," the liquidation would not be taxable; the old corporation's basis and its earnings and profits would be carried over to Fortuna; the "rental" payments would be dividends not deductible by Fortuna; and the taxability of respond-

[46] For simplicity, we are also ignoring the "sale" of the current assets to Fortuna.

ents' "rental" receipts, treated as dividends, would depend upon the earnings and profits of Fortuna, so determined (see §§ 301, 316, 354, 362, 381). If there was not a "reorganization," the liquidation of the old corporation would be a taxable event and respondents would be subject to a capital-gains tax, in the year of the liquidation, on a gain measured by the value of the corporate assets—a taxable event, it should be noted, very different from the stock "sale" claimed by respondents here, both in principle and in the measurement of the gain (see § 331). Even though there was no reorganization and the liquidation itself was taxable, however, there would remain essentially the same question whether the further "lease" of the assets to Fortuna for 80% of its net profits should be treated as giving rise to a "stock" interest in Fortuna on "thin capitalization" principles,[47] causing the "rental" payments to be treated as dividends, non-deductible by Fortuna and taxable to respondents on the basis of Fortuna's earnings and profits (though in that event there would be no carry-over of the old corporation's tax attributes) (see also § 351). If, finally, there was a taxable liquidation and the "lease" of the assets was accounted for as a true lease, respondents would presumably be entitled to claim depreciation deductions for the "leased" assets based on the value of the assets at which they were taxed on the liquidation.

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[47] See, e.g., *Gooding Amusement Co.* v. *Commissioner*, 23 T.C. 408, affirmed, 236 F. 2d 159 (C.A. 6); *Farley Realty Co.* v. *Commissioner*, 279 F. 2d 701 (C.A. 2); Surrey & Warren, *Federal Income Taxation*, pp. 1187–1204 (1960).

In the actual "combined" transaction—(1) a purported "sale" of the stock to the Institute followed by (2) the Institute's liquidation of the corporation and transfer of the assets to Fortuna—the problems presented by the subsequent steps (if the first step is held not to be a "sale") remain essentially unchanged. And it may yet be necessary to answer at least some of them (*i.e.*, on remand) to determine the tax character of the respondents' subsequent receipts—*e.g.*, whether they are "dividends" (and, if so, by whose earnings and profits their tax treatment is governed) or "rents" (and, if so, what basis respondents may use for depreciation). The only question that the combination of the several steps would seem significantly to affect is the question whether, if there was not a reorganization, the liquidation itself was taxable (see § 332) and, if so, to whom, the Institute (in which event its tax exemption would eliminate the tax) or the respondents (in which event they should have paid a capital-gains tax in 1953, the year of the liquidation). That question is a complex and difficult one, but since the Commissioner did not assert a tax against respondents on the liquidation—and since we may safely assume that respondents will not claim that it was taxable to them—the question is not presented in this case.

2. That brief analysis of the nature of the questions presented by the subsequent steps—none of which have yet been raised by the parties or considered by the courts below—is enough to show that they are in fact entirely separate from the question presented

here whether the initial step was a "sale." It also, however, has a second significance which, while not immediately relevant, may contribute to a fuller understanding of the transaction: to wit, it permits a reappraisal of the role actually played in such transactions by the tax exemption of the purported "buyer."

Inasmuch as the hoped-for elimination of the corporation income tax depends ultimately upon whether Fortuna may deduct the purported "rental" payments—and since, as we have shown, that question would be the same with or without the initial transfer of the stock to the Institute—the tax exemption does not itself contribute to the accomplishment of that object of the transaction. Its primary contribution is rather one that is dependent upon the success of the transferor's claim that the initial step of the transaction is a "sale": a necessary corollary of that claim, if upheld, would be that the remitted income is taxable to the transferee, a consequence that the use of a tax-exempt transferee guards against. If our contention that the transfer is not a "sale" is upheld, however, the use of the tax exemption in that respect will never become operative (except, of course, as to the 10% of the income actually kept by the Institute). The only other apparent contribution of the tax exemption is that it may, in the same way, serve to shield the liquidation of the old corporation from a capital gains tax—*i.e.*, if the liquidation would otherwise be "taxable" (*i.e.*, is not a "reorganization") and if the transferor's claim that it is not taxable to him is upheld or, as in this case, is not challenged. Apart

from those two consequences, however, it does not appear that the tax exemption makes any significant contribution to the transaction. That, of course, is not directly germane to the issue before the Court, but it may help to remove some of the obscurity that has surrounded the charity's role in these transactions.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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